



Achieving Financial Goals through Optimal Portfolio Management

The 7 Most Important Questions to Explore When Selecting Your Investment Advisor

1 What is my manager’s investment philosophy?

Over time advisor and client will navigate together through various life events and changing economic conditions to reach certain objectives. However, investment advisors’ philosophies vary significantly based on their educations, professional backgrounds, and business models. Thus, it is critical that the client’s beliefs be aligned with his/her advisor’s philosophy so that these changing events be viewed from an agreed-upon framework. One primary dimension of investment management philosophy is that of *active management* vs. *passive management*.

Brokers or advisors using active management strategies attempt to pick superior stocks or mutual funds and time investments in order to achieve higher returns than the market. Active management strategies are characterized by more frequent trading which inherently brings higher costs and taxes.

Philosophies of Large U.S. Asset Managers ¹



Passive management focuses on balancing risk across sectors (e.g. industries, geographies) and maintaining low costs through infrequent trading and index-based investments. With sophisticated asset allocation, passive management

strategies may achieve risk-adjusted, above-market returns. Passive management returns tend to map more closely to general market performance than active management strategies.

The academic community has embraced passive management for years. Following the work of a few noted Nobel Prize winners, several studies, both theoretical and empirical, have shown that passive management outperforms active management by 1 – 3% per year on average.²

The choice of either active or passive management style does not necessarily lead to a more aggressive or conservative strategy. Aggressive or conservative strategies can be developed within each philosophy.

Most U.S. investment assets reside in active management vehicles, although passive management vehicles like index-based mutual funds and Exchange Traded Funds (ETF's) are growing much more rapidly. The illustration above shows where some of the largest asset management institutions in the world reside on the continuum of active vs. passive management philosophy.

➤ ***Look for an advisor who invests in assets that fit your investment philosophy. If you do not have an investment philosophy, stories on stock picking vs. index funds or ETF's are presented in many print editions of The Wall Street Journal, Barron's, Fortune, and Bloomberg's Wealth Manager. Good online resources include Morningstar, Dimensional Fund Advisors, MotleyFool, MSN Money, and Yahoo!Finance.***

2 What will my total costs be?

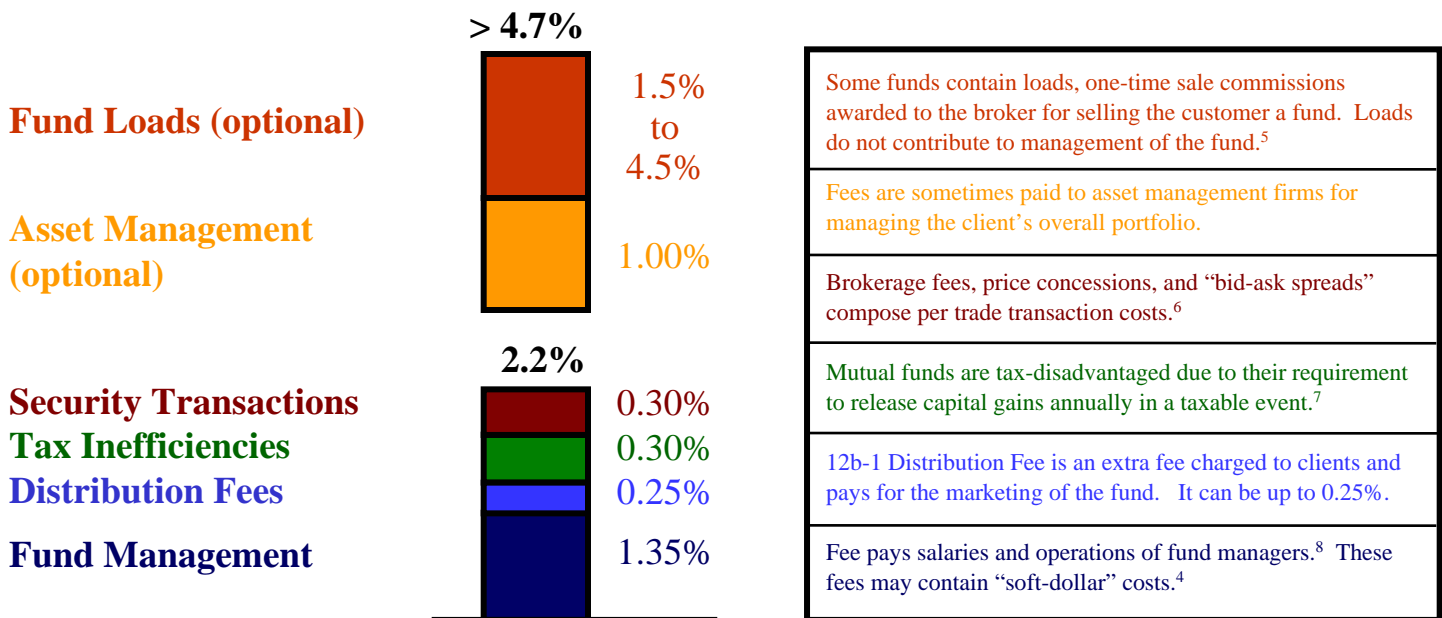
Optimizing a portfolio to gain every bit of expected return holds tremendous value. Elevating annual return slightly from 8% up to 10% (at the same risk) over the course of 20 years is worth approximately \$180,000 for every \$100,000 originally invested. This value can be automatically unlocked if an investor can lower total cost structure by 2%. Studies consistently show low total costs to be one of the leading predictors of total performance over long time periods.

The average mutual fund silently costs 2.4 – 2.6% annually in fund management costs, transaction costs, distribution fees, and tax inefficiencies.³ “Soft-dollar” brokerage commissions,⁴ asset management fees, and sales commissions (loads) are other potential costs. While most of these costs are publicly disclosed, frictional trading costs, tax inefficiencies, and “soft-dollar” brokerage commissions generally are not.

The chart below shows the components of an average mutual fund's total cost. Best practice examines the entire cost structure and seeks to minimize total cost. Cost minimization is one of the few “free lunches” in investing and is easily quantifiable.

➤ ***Ask your prospective advisor what each of these cost components are for a typical portfolio of your size. Look for an advisor who seeks to minimize total cost.***

Annual Portfolio Total Cost of Average Mutual Fund



3 How will my taxes be managed?

This question is more important for some investors than others. An investor holding only tax-sheltered accounts such as IRA's or 410(k)'s has less tax impact to manage. But an investor holding significant capital gains or requiring estate planning will have tax implications which require careful planning and management.

Investors with both taxable accounts and tax-deferred accounts can save significant tax dollars through clever allocation of assets across the different account types. College planning is another complex area in which a sophisticated strategy using a blend of 529 plans and custodial UTMA/UGMA accounts can maximize the tax benefits allowed for college savers while still providing flexibility for a variety of post-high school education options.

Investors with pending estate tax challenges can use gifting, 529 plans, pre-paid tuition, charitable giving, A-B trusts, or other estate tax reduction techniques at specific times to optimize an estate planning strategy in a world of uncertain tax legislation. Legislation is especially uncertain in upcoming years with arrival of the Obama administration, whereby it is unclear if and how congress will extend the 2003 investment tax cut laws set to expire in 2010. A good advisor will understand the state of the current tax bills in congress and adjust clients' strategies accordingly.

For investors in high income tax states such as California (9.3%), New Jersey (8.97%), North Carolina (8.25%), Iowa (8.98%), Minnesota (7.85%), and New York (7.7%), managing capital gains, dividends, and interest in a tax-optimal way is critical. Municipal bonds will often be a valuable part of portfolios for retired or high income investors in these states.

After-tax returns are not presented by advisory firms as often as pre-tax returns. But it is after-tax returns that really matter. As each investor has unique tax sensitivities, each investor's strategy should reflect his/her specific tax needs.

➤ *Look for an advisor who focuses on after-tax returns and can report returns and appropriate benchmarks on an after-tax basis, using your specific marginal tax rate.*

4 *How will my total portfolio risk be managed?*

We all understand market fluctuation and that we take some risk with our investment dollars. When judging portfolio performance, many errantly look exclusively at returns, as they are easily understood and frequently used in the media as a basis for investment comparisons. But when judging portfolio performance, risk must be considered as well as return.

For example, if your portfolio returned 12% while the general market returned 10%, you might be pleased initially. But what if you undertook twice the risk of the general market to get your 12%? In reality your portfolio underperformed on a *risk-adjusted* basis. You may have deserved nearly a 20% return in a rising market based on the risk that you assumed.⁹

Risk is less frequently reviewed because it is less intuitive; however, risk can be measured as price volatility -- how far a portfolio value swings up and down over time. A comprehensive portfolio risk analysis can identify imbalances and sensitivities to certain risks (e.g. currencies, geographies, oil prices, long-term interest rates, terrorism threats) and suggest ways of mitigating these risks in a cost-minimizing, tax-efficient way.

Portfolio management is even stronger when it factors assets beyond advisor management, such as investment real estate, stock options, or 401(k)'s. Your advisor should model how your portfolio value will likely change if your other asset values rise or fall significantly. Ideally, your managed portfolio will have a low correlation to these other assets.

➤ *Ask your prospective advisor how overall portfolio risk is measured and managed. Ask if your portfolio will be constructed to factor your other assets.*

5 *Is my advisor a Registered Investment Advisor or a broker?*

While most advisors may look the same, two distinct types of advisors exist, each regulated by state and federal governments in a separate manner. The *Registered Investment Advisor (RIA)* and the *broker-dealer* each have different ways of making money for their firms and so have different sets of rules governing operations. Investors should be aware of their advisor's designation and ensure that their financial objectives are aligned with that of their advisor's firm.

A RIA has a fiduciary responsibility to act in the best interest of the client. The source of RIA revenue typically comes from the client exclusively and not from any third party, such as a financial firm which compensates the advisor for placing clients into their mutual funds, annuities, REIT's or other investments. If an RIA is making money from a non-client source, they must clearly disclose this potential conflict of interest. Furthermore, RIA's are allowed to trade within a client's account at their discretion or develop financial plans if agreed to by the client.

Brokers are legally categorized as sales agents. They are not allowed to make discretionary trades (brokers must get client approval before placing trades) or to develop financial plans. They often generate commissions for themselves from

transactions within clients' accounts or from financial firms for selling certain products. Either of these revenue sources could potentially produce conflicts of interest. For example, a broker may have incentive to buy/sell more frequently, thus generating higher trading commissions, or to place clients in products which yield the highest sales commissions.

In April, 2005 the Securities Exchange Commission (SEC) adopted the so-called "Broker-Dealer Rule" which a) restricts brokers from trading on a discretionary basis or providing financial planning or similar services, and b) requires brokers to distribute a disclosure cautioning the client that the broker's interests may not always be the same as the client's.

➤ *Ask whether your advisor is an RIA or a broker. Whether your advisor is an RIA or a broker, ask for disclosure of all business revenue sources and of any possible conflicts of interest between firm profits and client risk/return.*

6 *What is my advisor's educational and experiential background?*¹⁰

Advisors, whether at an RIA or a brokerage firm, vary in education and professional background. Entrance to the brokerage or registered investment advisory business is relatively easy, requiring only the passing of Series 6 and/or 7 tests to achieve registration. Academic training beyond that varies widely. Thus, it is important to understand the advisor's academic background in addition to industry experience.

Investment advisors and brokers have developed a baffling array of titles and designations. These include Certified Financial Planner (CFP), Certified Financial Analyst (CFA), and Chartered Financial Consultant (ChFC). These designations are not required for registration but do give the public an indication of some level of training. It is important to note that these are not college degrees but rather designations, typically acquired by taking 2-6 classes from schools that belong to one of these programs.

Deeper education is associated with Bachelors, Masters, or Doctorate degrees in areas such as business, financial planning and portfolio theory. These degrees are typically held by the large institutional money managers. Furthermore, recent studies suggest that money managers holding MBA's from one of the top business schools outperform those who do not.¹¹

➤ *Look for a financial advisor with an advanced education who has focused on portfolio theory.*

7 *What has my advisor's average return been on a risk-adjusted basis?*

Objective academic studies show repeatedly that past performance is a poor indicator of future performance.¹² So while this question is popular due to its easily comparable quantitative answers, it is not as valuable as the previous questions for predicting future risk-adjusted performance.

Furthermore, when comparing past returns the investor must take special precaution to ensure an apples-to-apples comparison in terms of cost accounting, timeframe, sample group and risk.

➤ *Costs: Are the returns net of all costs? Are they before or after-tax? Are the tax rate assumptions consistent?*

- **Timeframe:** 1-year, 3-year, 5-year, and 10-year timeframes are most common. 5-year timeframes may be the best. Shorter timeframes may not have enough data while longer timeframes may represent a variety of strategies and managers over the years that differ from the current strategy and managers. Ideally, the timeframe would include both up and down market periods. In addition, comparable timeframes should match to the day. Daily market swings of over 2% were common from 2001 – 2005 while the total return of the S&P 500 Index over this five-year period was 2.7%.
- **Sample Group:** Performance quotes should cover an average of all of the advisor's clients. Advisors may manipulate data by showing specific favorable examples of client performance, rather than an average of all clients.

In the mutual fund world, this action appears subtly as so-called “survivorship bias”, whereby underperforming mutual funds are often dissolved into more successful funds in the family. Thus, when calculating performance across mutual funds within a family, the lower performing funds no longer exist and therefore cannot be counted in an “average” performance calculation.

- **Risk:** Are the returns adjusted to reflect the risk taken? From the logic outlined in #2, different returns are expected at different risk-levels, just as different speeds are expected if you are driving a Formula One race car or an SUV. A simple way to compare returns at a similar risk level is to adjust all returns to the same risk as the S&P 500 Index. Ask your advisor to use a Securities Market Line (SML) calculation to determine what his/her return would have been when normalized to the same risk as the S&P 500 Index.

➤ **Ask your prospective advisor how costs, taxes and risk are factored into return calculations. Also, when comparing returns, ensure that similar timeframes are used and that they include all client portfolios, including those who may have left the firm.**

Questions?
Contact us at:
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Notes and Acknowledgements:

1. Illustrative. Philosophies of major financial institutions are estimated by Sharper ♦ Granite.
2. Studies include:
 - a. Lipper Inc. reports a 1.5% annual underperformance by actively managed funds from 1993 - 2002.
 - b. The Vanguard Group reports a 3.0% annual underperformance from 1983 - 2002.
 - c. The *Wall Street Journal* study, "Stock Funds Just Don't Measure Up", October 5, 1999 reports 1.4% annual underperformance.
 - d. A University of Chicago study by Mark Cahart, Ph. D. reports a 1.8% annual underperformance from 1961 – 1993.
 - e. Blake, Elton and Gruber report a 1.6% annual underperformance from 1965 – 1984.
 - f. "Of course I favor passive investing for investors," *Investment Gurus*, "An Interview with Merton Miller", Ph. D., Nobel Laureate Economics, Harvard Business School, conducted by Peter Tanous, New York Institute of Finance, February 1997.
 - g. "Properly measured, the average actively managed dollar must under-perform the average passively managed dollar, net of costs," *The Arithmetic of Active Management*, William Sharpe, Ph. D., Nobel Laureate Economics, University of Stanford Graduate School of Business.
3. Vanguard Group shows a 2.4% average fund cost from 1996 – 2005. Lipper Inc. shows 2.6% average fund cost from 1997 – 2001.
4. Lipper Inc. "Soft dollar" costs are the undisclosed overpayments of brokerage commissions in exchange for research or other products.
5. Sales fees (loads) are one-time. Average mutual fund holding period is 2 ½ years according to Morningstar Inc.
6. Security transaction costs average 0.3% of cost for mutual funds with a 100% turnover rate according to "Trading Cost: The Critical Link Between Investment Information and Results," Thomas F. Loeb, *Financial Analysts Journal*.
7. Tax costs average 0.5% of cost for mutual funds with a 100% turnover rate according to Vanguard Group.
8. Average fund management fee for 2005 was 1.35%, Lipper, Inc.
9. If the risk-free rate = 0%, then a portfolio with 2X general market risk would have 2X the expected return per the Capital Asset Pricing Model (CAPM).
10. Information included from: "Wait, Let Me Call My ChFC", *Wall Street Journal*, January 27, 2006; and "Who Can You Trust? Who Should You Use? Who Knows Anything?", Errol F. Moody Jr., Ph. D., M.B.A., B.S.C.E., L.L.B., M.S. in Financial Planning, and RIA.
11. Aron Gottesman and Matthew Morrey, Lubin School of Business, Pace University, as reported in the *Wall Street Journal*, December 12, 2005.
12. a. "All the studies have found that there is no correlation between the actively managed mutual fund results of the previous years and their performance in subsequent years," *Investment Gurus*, "An Interview with Merton Miller", Ph. D., Nobel Laureate Economics, Harvard Business School, conducted by Peter Tanous, New York Institute of Finance, February 1997.
- b. "We took ten years of mutual fund data from *The Top 20 Morningstar funds* and looked at their performance for the following ten years and found that there was no correlation. Actively managed mutual fund investing has all the earmarks of a random process." Eugene Fama, Ph. D., University of Chicago Graduate School of Business.