Do They Eat at Home? Guides to Choosing a Money Manager
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Do They Eat at Home?

Guides to Choosing a Money Manager

By SETH A. KLARMAN

INVESTING is a full-time job. Given the vast amount of information available for review and analysis and the complexity of the investment task, a part-time or sporadic effort by an individual investor has little chance of achieving long-term success. It is not necessary, or even desirable, to be a professional investor, but a significant, ongoing commitment of time is a prerequisite. Individuals who cannot devote substantial time to their own investment activities have three alternatives: mutual funds, discretionary stockbrokers, or money managers.

Mutual funds are, in theory, an attractive alternative for the individual investor, combining professional management, low transaction costs, immediate liquidity and reasonable diversification. In practice, they mostly do a mediocre job of managing money. There are, however, a few exceptions to this rule. . . .

Some open-end mutual funds do have a long-term value-investment orientation. These funds have a large base of loyal, long-term-oriented shareholders, which reduces the risk of substantial redemptions that could precipitate the forced liquidation of undervalued positions into a depressed market.

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SOME stockbrokers function as money managers, having discretionary investment authority over some or all of their clients' funds. Practices such as these may entail serious conflicts of interest, made on the basis of trading commissions rather than investment results. Nevertheless, you would select a discretionary stockbroker just as you would choose a money manager. The questions to be asked are virtually identical.

The ultimate challenge in selecting a stockbroker or money manager is understanding precisely what they do, evaluating the validity of their investment approaches (do they make sense?) and their integrity (do they do what is promised, and is it in your best interest?).

How do you begin to evaluate stockbrokers and money managers? There are several important areas of inquiry, and one or more personal interviews are absolutely essential. There is no better place to begin one's investigation than with personal ethics. Do they "eat home cooking"—managing their own money in parallel with their clients? I can think of no more important test of the integrity of a manager and the likelihood of investment success than his or her own confidence in the approach pursued on behalf of clients. It is interesting to note that few, if any, junk-bond managers invested their own money in junk bonds. In other words, they ate out.

Another area of inquiry concerns the fair treatment of clients. Are all clients treated equally? If not, why not, and in what ways? Are transactions performed for all clients contemporaneously? If not, what method is used to ensure fairness?

A third area of interest concerns the likelihood of achieving good investment results. Specifically, does the broker or money manager oversee a reasonably sized portfolio, or have the assets under management grown exceedingly large? One way to judge is to examine the manager's track record since the assets under his or her control reached approximately the current level. Investors can also examine the records of other managers to determine in general how increased size affects performance. In my experience, large increases in assets under management adversely affect returns. The precise amount that can be managed successfully depends on the specific investment strategy employed as well as the skills of the manager under consideration.

A fourth area of inquiry concerns the investment philosophy of the manager. Does the broker or money manager have an intelligent strategy that is likely to result in long-term investment success? (Obviously, in my view, a value-investment strategy would be optimal.) Does he or she worry about absolute returns, about what can go wrong, or is he or she caught up in the relative-performance game? Are arbitrary constraints and silly rules, such as remaining fully invested at all times, absent?

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THE decision to employ an investment professional should be made only after a thorough analysis of the past investment performance of the individual or organization under consideration. Some questions are obvious: How long a track record is there? Was it achieved over one or more market and economic cycles? Was it achieved by the same person who will manage your money, and does it represent the complete results of this manager's entire investment career or only the results achieved during some favorable period? (Everyone, of course, will be able to extract some period of good performance even from a lengthy record of mediocrity.) Did this manager invest conservatively in down markets, or did clients lose money? Were the results fairly steady over time, or were they volatile? Was the record the result of one or two spectacular successes or of numerous moderate winners? If this manager's record turns mediocre after one or two spectacular successes are excluded, is there a sound reason to expect more home runs in the future? Is this manager still following the same strategy that was employed to achieve his or her past successes?

Obviously a manager who has achieved dismal long-term results is not someone to hire to manage your money. Nevertheless, you would not necessarily hire the best-performing manager for a recent period, either. Returns must always be examined in the context of risk. Consider asking whether the manager was fully invested at all times or even more than 100% invested through the use of borrowed money. (Leverage is neither necessary nor appropriate for most investors.) Contrariwise, if the manager achieved good results despite having held substantial amounts of cash and cash equivalents, this could indicate a low-risk approach. Were the investments in the underlying portfolio themselves particularly risky, such as the shares of highly leveraged companies? Conversely, did the manager reduce portfolio risk through diversification or hedging or by investing in senior securities?

When you get right down to it, it is simple to compare managers by their investment returns. . . . It is far more difficult—impossible except in retrospect—to evaluate the risks that managers incurred to achieve their results.

Investment returns for a brief period are, of course, affected by luck. The laws of probability tell us that almost anyone can achieve phenomenal success over any given measurement period. It is the task of those evaluating a money manager to ascertain how much of past success is due to luck and how much to skill.

Many investors mistakenly choose their money managers the same way they pick horses at the race track. They see who has performed well lately and bet on them. It is helpful to recognize that there are cycles of investment fashion; different investment approaches go into and out of favor, coincident with recent fluctuations in the results obtained by practitioners. If a manager with a good long-term record has a poor recent one, he or she may be specializing in an area that is temporarily out of favor. If so, the returns achieved could regress to their long-term mean as the cycle turns over time; several poor years could certainly be followed by several strong ones.

Finally, one of the most important matters for an investor to consider is personal compatibility with a manager. If personal rapport with a financial professional is lacking, the relationship will not last. Similarly, if there is not a level of comfort with the particular investment approach, the choice of manager is a poor one. A conservative investor may not feel comfortable with a professional short-seller no matter how favorable the results; by contrast, an aggressive investor may not be compatible with a manager who buys securities and holds them.

Once a money manager has been hired, clients must monitor their behavior and results on an ongoing basis. The issues that were addressed in hiring a manager are the same ones to consider after you have hired one. ■

Seth A. Klarman directs the Baupost Group, a Cambridge, Mass.-based money-management firm of which he is a founding partner. This article is excerpted from his forthcoming book, At the Margin of Safety: Going Beyond Financial Myth Making to Find Real Investment Value, *to be published by HarperBusiness in January. Copyright 1991 by Seth A. Klarman. By arrangement with HarperCollins Publishers.*

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