

## Five Mistakes to Avoid When Choosing a Money Manager

### 1. Choosing Only One Manager

Savvy investors know they should diversify their portfolios. However, they may not realize that putting all their assets with a single money manager usually will not diversify them adequately.

Most money managers specialize in a single strategy. They might be experts at small, growth stocks, tax-free fixed income, or large, value stocks. Very few managers can be good at more than one strategy. Those few who are often apply their unique selection process to more than one asset class. The manager that can deliver consistently good performance, managing every asset class and style, does not exist.

According to Modern Portfolio Theory, to adequately diversify your portfolio, investments must be spread among different classes of assets whose returns are not highly correlated. This way, when one asset class goes down in price, another does not necessarily follow suit. Different economic conditions favor different asset classes.

As you can see on the Value of Diversification chart on our web site, illustrating how different Asset Class Returns have performed over time, the same asset class is rarely the top performer more than one year in a row. If you have only one manager, and your manager happens to invest in that asset class—lucky you. However, you would need switch managers every year, and be very lucky indeed to always pick a manager specializing in the top performing asset class next year.

Based on the groundbreaking work of Harry Markowitz and William Sharp, Modern Portfolio Theory asserts that investors should allocate their assets among different classes and match their asset allocation to their tolerance for risk. Risky portfolios get higher average returns, but those returns swing more wildly from year to year than the returns of less risky portfolios. There are years in which they lose a lot of money. Less risky portfolios don't fluctuate as wildly, but return less on average.

Since money managers concentrate in one, or a few, asset classes or styles, you need a portfolio of several managers to adequately diversify. At WrapManager, before we recommend a manager, we assess your goals in life and your level of comfort with risk. We craft an asset allocation tailored to your goals and risk level. Then we choose from

among hundreds of managers available to us and pick the ones best suited to you. We will also sometimes use bonds or exchange traded funds to round out your portfolio.

Investing with only one manager who can not adequately diversify you can be a costly mistake.

## 2. Choosing Last Quarter's Top Performer

Investors who chase performance often end up buying high and selling low. What's past is prologue. While performance is important, it is also history. It is important to ask: "Why was this manager a top performer last quarter?" Without careful analysis it can be difficult to separate the manager who finally got lucky once—after ten years in business—from the one who is consistently good and just turned in his best quarter ever.

Why was this manager a top performer? One clue is to look at the other top performers and their strategies. If most of the top performers were Small Cap Value managers, who invest in small companies that they feel are undervalued for some reason, this tells us that the economic conditions favoring these stocks are driving their returns. The market is being good to many Small Cap Value managers, including this one.

So the next question is: How long will this trend continue? As you can see on the Value of Diversification chart on our web site, illustrating how different Asset Class Returns have performed over time, the same asset class is rarely the top performer more than one year in a row. As the economy moves through cycles different asset classes are favored. Long term investors will pick good managers in several different asset classes so they don't have to try and guess which one will be the next winner.

So how *should* you pick a manager? First, you should not pick just one (see Mistake Number 1). That said, there is no one right answer and there are many factors to consider, including the manager's experience, the economic outlook, the current market attitude toward a given manager's strategy, and your personal level of tolerance for risk. But, when evaluating performance, we compare managers of the same asset class and style on a number of factors including things like:

1. Consistency – We look for managers with consistently good returns over a number of years, in all kinds of markets. The manager who is never number 1, but always a top contender is often a better choice than one that was number one last quarter, but an also-ran in five of the past eight quarters.
2. Alpha – Sorry, we're going to talk math for a moment. Alpha is a statistical measure of excess returns over the market. Generating Alpha consistently over time, say three

- to five years, is very hard. Look for an Alpha greater than 0. The higher the manager's Alpha, the better.
3. Sharpe Ratio – Again with the math! The Sharpe Ratio measures risk adjusted returns. Managers who take more risks than the market should get higher returns, at least when the market goes up. A Sharpe ratio greater than 1 means that the manager is getting excess returns over those expected for the amount of risk he is taking. The higher the manager's Sharpe ratio, the better.

As a wealth manager, WrapManager works for you, not for any particular money manager. We can put together a portfolio of managers who employ a variety of strategies. Such a portfolio is designed to help you reach your financial goals without taking more risk than you are prepared to accept.

### **3. Choosing Managers Without Setting Goals**

If you don't know where you are going, how can you choose a path? The right money managers are a critical factor in your investing success, but they are means to an end. Without a clear definition of what success looks like, how can you decide which ones will take you where you want to go?

Successful investing is a lifelong journey. Before you embark on that journey, it pays to spend a little time considering your destination. This is important because investing involves taking risk. As a rule, you don't want to take any more risk than is necessary. How much risk is necessary? That depends, in part, on how much money you'll need to reach your goals. How much money will you need? That's the question a Goal Plan can answer.

Before choosing managers or even creating a portfolio allocation your WrapManager Strategist will create goal plan to be sure we understand what you need your money to do for you in the future. What are your goals in life: security in retirement, education of your children, a vacation home, or travel? How much you'll need and when you'll need it are important elements of a successful investment strategy.

A second vital element of the plan is your risk tolerance. Risk tolerance has two components: your personal level of comfort with risk and your stage of life. Even if an 85 year old is a wild, crazy risk taker, her appropriate allocation may be conservative simply because of her current income needs.

Only after we understand your risk tolerance and goals will we create a strategic asset allocation for you and recommend a group of managers and perhaps other assets that will bring that strategy to life. We feel that it can be a critical mistake to invest your money without first giving careful thought to your goals and risk tolerance.

#### **4. Failing To Monitor Your Managers**

Things change. The economy changes. The political environment changes. Your goals, needs and risk tolerance may change as you mature. Choosing a manager is just the beginning of a long term relationship. Your plan and your managers need to be monitored over time to be sure that they are still working for you.

Both your plan and the performance of your managers must be monitored and reviewed regularly. At WrapManager, your Investment Consultant continually monitors manager performance and reviews each client's plan on a quarterly basis to be sure both are on track. If your plan is off track we can suggest adjustments. If a manager needs to be replaced, we replace him.

Since investing is a long term activity, your plan may change over time. Your life may change in unexpected ways, for better or for worse. Children, divorce, career advancement, disability, inheritance, and a host of other things could change your goals or your risk tolerance. Your plan needs to respond to the changing realities of your life and adapt to serve your changing needs.

Even the best manager relationships may someday end. Sometimes a manager's performance deteriorates or they drift from the strategy that made them successful. Sometimes, you reach your goals and the manager's strategy is no longer a good match for you. Since we work for you—not for the asset managers—your WrapManager Investment Consultant won't hesitate to recommend a change when it is appropriate for you. We have access to hundreds of manager strategies and can always find one that meets your needs.

#### **5. Measuring Performance Against The S&P 500**

When does beating the S&P 500 by 5% make a manager a poor performer? When the manager's strategy is significantly different from the S&P 500 it might. One example would be if that manager ran an international portfolio in 2006.

In 2006, the S&P returned 15.8%. However, the appropriate international benchmark—MSCI EAFE—was up 26.9%. If an international manager returned only 21% he would have beat the S&P handily, but not done so well against his peers. (MSCI EAFE stands for Morgan Stanley Capital International Europe Australasia and Far East index. It is the appropriate benchmark for most diversified international funds.)

Another example might be a manager of a balanced portfolio of stocks, bonds and cash. This manager seeks to reduce risk by placing money in more than one asset class. This strategy is inherently less risky than the 100% large cap equity composition of the S&P 500. It would be expected to produce a lower return on average because it is less risky. In this case a blended benchmark that reflects the asset mix of the manager might be a more accurate point of comparison.

The S&P 500 is a useful benchmark for choosing a large cap core manager. However, for other strategies, comparing a manager's performance against the S&P 500 is irrelevant. The S&P 500 represents only the very largest companies in the US. Different asset classes and styles behave differently and don't necessarily move in the same direction at the same time. For instance managers of small capitalization or mid cap portfolios are better judged against one of the Russell indices.

At WrapManager when we choose managers and monitor their performance, we measure them against an index that is appropriate for that manager's strategy. When we present their performance to you we display it against a blended benchmark representing the asset classes in your custom portfolio.

For more information, please contact us at (800) 541-7774 or click for a [FREE Money Manager and Asset Allocation Proposal](#) today.

This report and information have been prepared or produced by WrapManager, Inc. WrapManager, Inc. is an investment adviser registered with the United States Securities and Exchange Commission. This document is being sent for informational purposes and is not to be construed as an offer to sell or the solicitation of an offer to buy any security in any states where such an offer or solicitation would be prohibited by regulations. Past performance is not indicative of future results, therefore, no investor should assume that future performance of any investment or product made reference to will be profitable or equal the corresponding performance level(s) indicated. Different types of investments involve varying degrees of risk, and there can be no assurance that any specific investment will either be suitable or profitable for your investment portfolio. Information pertaining to WrapManager, Inc. and preferred Money Managers' operations, services, and fees are set forth in the respective firms' disclosure statements, copies of which are available upon written request. Opinions expressed are subject to change without notice. WrapManager, Inc. is not a tax advisory firm. We recommend you contact your tax attorney or CPA prior to utilizing any of the tax-related strategies mentioned. Securities offered through Prospera Financial Services and cleared through First Clearing, LLC. Prospera Financial Services—Member, NASD/SIPC. The strategies used by the Money Managers listed above are not suitable for all investors. The information presented is general information that does not take into account your individual circumstances, financial situation or needs, nor does it present a personalized recommendation to you. Therefore, prior to selecting a Money Manager it is important you discuss the manager with your financial advisor. Your financial advisor can help you determine proper suitability constraints and objectives as determined from your individual needs and circumstances. A Money Manager should only be selected if the manager is appropriate for the individual investor.

© Copyright 2008, WrapManager, Inc. All rights reserved.