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Think before firing that fund manager

Michael Nairne, Serious Money

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You're fired! That's easy for Donald Trump to say because he's rich. But for most mutual fund investors, it may not be that simple.

You're fired! As investors react to their 2010 returns, many underperforming managers will be on the receiving end of these harsh words. U.S. mutual fund data indicate more managers are finding their heads on the chopping block these days. The average tenure of a fund manager in an investor's portfolio was 2.9 years in 2008, down from 4.4 years in 2005.

Unfortunately, many firings are ill considered and are likely to detract from portfolio performance.
A 2008 landmark study on the results of institutional selection and termination decisions found that the performance of fired managers exceeded that of the managers hired to replace them for the one, two and three years analyzed post the firing decision.

Even when pricey consultants advised on the decision, the replacement managers had inferior returns to the fired managers. It seems "the devil you know" is, indeed, better when it comes to investment managers.

Firing a manager heaps costs on a portfolio. Hedge and mutual funds often have redemption or deferred sales charges.

Commissions can skyrocket when dozens of bonds and stocks need to be sold and bought in the course of moving between separately managed accounts.

Transfer-out charges can mount up for a household with multiple open, RRSP and TFSA accounts.

For affluent investors, the triggering of hefty capital gains taxes is an oft-ignored expense.

Bad hiring unquestionably contributes to the frequency of firing. Because many investors chase returns, turning a blind eye to diversification, they end up with a portfolio overly weighted with the latest hot managers.

These days, managers with heavy exposure to mining, precious metals and small company stocks are roaring ahead of the broader market indices.

You can bet many investors will flock to such managers in 2011 thereby setting up the next round of firings when these sectors plummet -- as they have in the past and eventually will again.

Investor impatience is another source of unproductive firings. Even top managers have lengthy periods of underperformance. A recent study in the United States by DiMeo Schneider & Associates found that a full 85% of top quartile mutual funds for the 10 years ended Dec. 31, 2009 had spent at least one three-year stretch in the bottom half of their peer group.

If you believe your manager will outperform in the future, patience is critical.

There are good reasons for terminating a manager. Some investors collect funds like some people collect stamps. I have seen investors who have many dozens of managers, many of them needless duplications that usually result in unnecessary costs and taxes.

If a portfolio has gaping holes in its diversification, it may be essential to reallocate capital to new managers. In my experience, many Canadian investors are woefully underinvested in Europe, Asia and emerging markets and often have an excess of Canadian and U.S. managers.

One of the soundest reasons for firing a manager is where a suitable replacement can be found at a lower cost. Increasing competition among exchange-traded fund providers, in particular, is causing a steady stream of lower-cost options that merit attention.

When underperformance is accompanied by material changes within the investment management company, warning signals should go off.

Senior management changes and a swelling in new product launches, for example, may signal a shift in focus from investment excellence to asset gathering. The departure of key personnel, particularly lead managers, is always a cause for concern.

A change in your financial circumstances may also necessitate manager terminations.

For example, an unexpected job loss may dictate a reduction in equity exposure and managers.

Firing managers is easy. Avoiding bad firing decisions is difficult.

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