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It's that big tomato you'll want

Ensure your advisor doesn't disguise results

Michael Nairne, Serious Money

There's an old saying that if you want to win a contest for growing the largest tomato, paint a cantaloupe red and hope the judges don't notice. Serious investors keep this principle in mind when they evaluate their investment managers. They don't only look at performance, but also seek to identify the risks taken by a manager in order to sort the real performers -- the large tomatoes -- from the painted cantaloupes.

This isn't as easy as it seems. Take Canadian equities in 2009 for example. Suppose a manager hired to invest in large Canadian companies delivered a stunning 45% return in 2009, far ahead of the 35% return of the S&P/TSX composite index. Is this a big tomato or a painted cantaloupe? You won't know unless you take a closer look. If, on reviewing the fund's holdings over the year, this particular manager had strayed from his mandate and had invested in riskier small company stocks -- a group that enjoyed an explosive 62% return in 2009 -- then this is a painted cantaloupe. This manager's excess performance is due to exposure to a much riskier segment of the market, a mandate for which he was not hired.

On the other hand, if the manager's excess return is due to his selection of a number of outperforming large company stocks, then you have a large tomato.

Determining whether a manager is a large tomato or a painted cantaloupe starts by defining their role at the outset. Much like pension funds, serious investors hire individual managers for specific roles in accordance with the asset and style mix parameters of their overall strategy. Just like a basketball team has guards, forwards and a centre playing designated roles, a good investment team is comprised of different managers with varying skills and mandates.

Once a manager's role is defined, any drift from that role, particularly taking on unauthorized risks, is unacceptable. One wealthy family I know separates its hedge-fund managers by strategy and volatility,

with the low volatility team charged with targeting moderate returns while the other targets market-beating returns. This family gets as concerned about a low volatility manager suddenly posting sizzling returns as they do about a more volatile manager chronically underperforming -- they learned long ago that risk and return go hand in hand.

Unfortunately, over time, many investment managers become painted cantaloupes. The competition for outsized returns is so great that some managers take on unacceptable risks in their pursuit of top numbers. This occurred during the tech boom when many managers ended up heavily over-weighted in technology stocks just as the bubble burst.

It is particularly true for some hedge-fund managers where excessive leverage and concentration can dramatically increase risk. The blowup of Amaranth Advisors, a multi-strategy hedge fund, due to excessive bets in the natural gas market in 2006 is a classic example.

Of course, there is a third category in all this -- small tomatoes. These are the managers who, net of their fees, don't beat their benchmarks over time. In fact, numerous studies indicate that over the long run, most managers end up in this category. Hence, many sophisticated investors have found that index funds, particularly value index funds, grow the largest tomatoes over time.

If active managers are to be hired, careful selection based on many years of data is critical; this is the only way to separate the skilful from the merely lucky.

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