

Making the Grade

Nearly every practicing CPA has been asked by a client, “Is my money manager doing a good job?” Your client recognizes that their money manager is disqualified from providing an unbiased response to this question. Clients also distrust the “free analysis” offered by other money managers who are competing for their business. And so you, the CPA, are your client’s only adviser who they can trust because you are truly objective.

This question is more complex than it might seem. Implicit are other questions:

- Is the return that was produced consistent with my objectives?
- Was the performance consistent with the manager’s peer group?
- Is the portfolio reasonably allocated?
- Are the fees being paid fair?

These are the types of questions that deserve a thoughtful investigation. And if you do not do it, who will?

The data collection needed to answer these questions does not require the CPA to have a securities license or even a depth of familiarity with investment practices. Instead, what is needed is the skill and experience to administer a process-based inquiry for which a CPA is trained. The data required to conduct this inquiry is fairly easy to access if one knows where to look or how to ask for it. For the most part, investment managers have access to sophisticated performance and reporting software that can be relied upon. Unfortunately, few money managers voluntarily present this data to their clients, and few clients have the industry acumen to request it. The CPA, as an unbiased adviser, is well positioned to administer this data gathering exercise.

The Baseline

The investigation must begin by documenting the actual performance that your client has experienced during their tenure with the manager in question. In addition to collecting your client’s actual return experience, you will need to collect the monthly return series and



an investment policy statement—if one has been developed. Sample text for this phase of the data collection process follows:

“Please forward to me the returns for the portfolio, both annualized since inception and as a monthly return series for this period, along with a copy of your Investment Policy Statement and asset allocation targets.”

Targeted Rate of Return

Once the client’s return experience has been collected, the CPA will help the client define the targeted rate of return that is needed to support the financial objective for the capital being invested. This is financial planning at its most fundamental level. You can arrive at this targeted rate of return by using the time value of money functions familiar to most financial professionals. This then is the primary objective of the portfolio, the outcome for which the money manager was engaged. Once the targeted rate of return has been defined, the CPA will inquire of the manager what return they expect the portfolio to produce long term:

“Please provide your best estimate for what the portfolio will return over the long-term.”

How to Answer: ‘Is My Money Manager Doing a Good Job?’

Portfolio Benchmark

Next, the CPA will collect the return history for a benchmark that reasonably approximates the risk and return characteristics of the client’s overall portfolio. Unfortunately, few money managers clearly define or publish such a thing. Instead, their benchmark is often represented by some portion of the investment universe (e.g., S&P 500, MSCI World, Barclays Aggregate Bond). But if the benchmark does not represent that mix of assets that the client actually owns, the benchmark will not be useful.

The manager’s benchmark also may compare the underlying securities they have selected to the sub-asset classes represented in the portfolio. Yet an analysis of the parts may not provide meaningful information about the whole. What the CPA is trying to infer is whether the combination of products the manager has selected represents a risk and return profile that would be reasonably expected to produce the client’s targeted rate of return.

“Please provide the monthly return series for a blended benchmark of major asset classes that reasonably approximates the risk and return characteristics of the portfolio since inception.”

As an aside, most money managers will be able to easily provide the performance data noted above. Those who are not comfortable with this level of independent review, or are unable to produce this fundamental performance information, deserve a more sober evaluation of whether the trust placed in them is justified.

Evaluating Actual Returns to Key Performance Indicators

Equipped with the client’s actual return, the targeted rate of return and a portfolio benchmark, an observation can be made whether the client’s objectives have been accomplished. It should be noted that this performance analysis is not conclusive in itself. The size of the data sample, the manager’s particular strategy and the client’s own instruction to

the manager can materially affect the over- or under-performance of the portfolio relative to the targeted rate of return and blended benchmark. This analysis merely provides the empirical data upon which informed conversation can be based. Without this data, the client is left to blindly trust that the manager's claims of being "above average" are accurate.

Diversification

Besides the performance evaluation noted above, the level of diversification within the portfolio also deserves investigation. Unfortunately, the monthly account statements provided by the vast majority of investment custodians do not provide concise allocation data to provide for this inquiry. A CPA advocating on behalf of a client will make the following request of the money manager:

"Please provide a breakdown of the portfolio across the following asset classes:

- Stocks v. Bonds v. Other Asset Types
- U.S. Stocks v. Non-U.S. Stocks
- Large Stocks v. Midcap and Small Stocks
- Value Stocks v. Growth Stocks
- Short Term Bond v. Long Term Bonds
- High Quality Bonds v. High Yield Bonds
- Liquid Assets v. Assets that cannot be liquidated within 5 business days"

Fees

Fees reduce investor return, but this is not to say paying fees is unreasonable. On the contrary, engaging with a qualified and thoughtful money manager to help implement an investment portfolio can be some of the best money a client will ever spend. Nevertheless, fees range from those that are "low" to those that are objectively "high." A determination of whether the money manager's fee falls within a reasonable and customary range deserves evaluation. As a guideline, a "fair fee" for a \$1 million portfolio holding a blend of stocks and bonds would normally fall between 0.9 percent and 1.2 percent. Obviously, in addition to this fee are the underlying costs of the investment products the manager has selected, which could add an additional 0.5 percent to 0.7 percent to the overall investment cost. Sample language for the CPA's data collection relative to fees follows:


"What are the managed fees charged by your firm for the portfolio during the last 12 months as measured in dollars and as a percent of the total portfolio, and what additional product level and transaction based fees have been paid during this period?"

Disclosure Events

An additional inquiry should be made to deter-

mine if any reporting events such as complaints, settlements or felony convictions have been filed with the regulatory bodies through which the manager is licensed. All of these reporting events are compiled in one easy-to-access disclosure site maintained by FINRA at www.brokercheck.org. Simply type the manager's name into the database and find out if there are any skeletons in the investment adviser's closet that your client might want to know about.

Conclusion

Your client's question, "Is my money manager doing a good job?" is the consequence of a general lack of disclosure and accountability endemic to the investment management industry. The CPA, with a wealth of experience in data collection and unbiased professionalism, is ideally positioned to help clients conduct a thoughtful and diligent investigation to answer this question. 

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