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What to look for during your annual evaluation of your investment manager

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This is the time of year when investors get a good look at their portfolios and how well they performed in 2016. Fortunately, the reporting is now somewhat standardized under the new Client Relationship Model (CRM II) guidelines, whereby managers are now required to show compensation paid in dollars along with performance in both absolute dollars and percentage terms.

However, there are some voluntary disclosures that are recommended but not required, making some reports more comprehensive than others. This could create challenges when conducting your annual review.

In these cases, it may be worth setting up a meeting with your manager to go through the report in more detail to ensure your portfolio is being properly looked after. To help, here are a few tips or things we look for when conducting reviews of our OCIO clients' investment managers.

Don't focus too much on near-term performance

Performance reporting is not required for periods prior to Jan. 1, 2016 under the new guidelines, but it is recommended. This is important as 12-months in our opinion is not long enough of a time frame to properly judge how well your manager has done looking after your portfolio.

Therefore, request three- and five-year performance results along with annualized since inception (both in dollars and percentage) as this gives a much better snapshot. Then match these returns with your investment plan to see if you are on track with your goals or not.

Time-weighted versus money weighted

Portfolio returns are required to be presented on a money-weighted basis, which in most circumstances is the proper way to gauge your performance. However, there are times that time-weighted returns make more sense and are a fairer way of judging the performance of your investment manager.

Money-weighted is a return metric that includes the effects of external cash flows (i.e. contributions/withdrawals) and measures the actual return an investor receives whereas time-weighted excludes the effect of these cash flows.

A time-weighted return can be particularly useful when the manager has not been responsible for the timing of large inflows into or outflows from the portfolio during market highs or market lows and so they should not be rewarded or penalized for this.

Benchmarking

Benchmarking is not required but we think it should be obtained if not already disclosed. However, the proper benchmark should be derived.

For example, a portfolio heavily concentrated in large-cap Canadian equities should be compared to the S&P TSX while a large-cap global equity portfolio to something like the MSCI World Index.

Balanced portfolios could be compared to other balanced funds out there, whether domestic focused or global with averages available by Thompson Reuters Lipper. They can also be compared to passive benchmarks comprised of ETFs weighted accordingly to bonds and equity ETFs.

There are also those managers out there that may not have a benchmark other than a long-term target return based on a spread to interest rates. It would be unfair to compare these to an equity index if their investment philosophy and strategies are more focused on risk-managed absolute returns.

That said, don't be too hard on them if they do not track all of the upside during market rallies, as long as they protect some of the downside during corrections and therefore are able to meet their long-term target returns when averaged out.

Risk measurements

While not a requirement, most managers should be able to provide measurements such as the portfolio's standard deviation, which can be used to measure the return generated per unit of risk taken as shown in the Sharpe Ratio. This way you can determine if those managers who generated a high level of return took excessive risk with your portfolio, which could spell trouble in the event of a correction.

Fees

Finally, fees are always a touchy subject for those in the industry especially now that total compensation to the manager must now be disclosed to the client.

We think a fair fee should at least be under 1.5 per cent for those portfolios under $1 million and should significantly drop with a sliding scale from there for larger amounts. This includes all fund and ETF fees plus any and all compensation to the person managing your portfolio.

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