Reprinted from:
THE NATION'S OLDEST WEEKLY BUSINESS JOURNAL
DENVER BUSINESS JOURNAL
VOL. 58 NO. 21 November 24-November 30, 2006 40 PAGES $2.00

Compliments of

Focus on investment portfolio's weaknesses

RICHARD TODD

PERSONAL FINANCE

It's guaranteed: Investment firms will highlight their strengths and downplay their weaknesses during presentations and in their pitch books.

A key component in a sound due-diligence process is examining the weaknesses. A large part of building a diversified portfolio of strategies and products is to make sure that weaknesses, especially in strategy, aren't glaring.

Markets and strategies will go through cycles, and it's important that advisers and investors understand all characteristics, especially weaknesses.

Where can investors find weaknesses? Some examples:

• **Benchmarking** -- Understand the universe from which a manager is selecting securities and the correct corresponding benchmark.

Many managers have dipped into small and mid-cap stocks but often compare performance against the S&P 500 large-cap index. With small and mid-caps outperforming consistently for seven years, "outperformance" can be misleading.

• **Luck or skill?** -- Many all-cap domestic equity managers gloat about recent performance against a broad benchmark such as the S&P 1500 or Russell 3000 indexes. The problem is that these indexes are cap-weighted; the larger the company, the more influence it has on the performance of the index.

If a manager's performance is compared to an index with equally weighted stocks, a better judgment as to luck or skill can be made. Managers that are sector allocators can add value over time, but don't be swayed by short track records.

Having an overweight in financial stocks has paid handsomely in the last few years, but was it by chance or skill? Performance of sector rotators must be reviewed for various cycles.

• **Review subperiods** -- Each manager and strategy have short periods of good performance and poor performance.

Understand why performance happened and whether underperformance is tolerable in the context of the investor's entire portfolio.

The last 10 years have been a pretty good test for strategies. The 1990s were strong growth equity markets, followed by the worst stock market since the Great Depression, followed by a strong rebound.

The last seven years have been terrific for small stocks. Within those periods, there are pockets that are interesting to examine, such as the Russian debt crisis in 1998 and the terrorist attacks of Sept. 11, 2001. The one scenario that hasn't been tested for 10 years is a rising interest-rate environment on the long end of the yield curve, as rates have generally come down. Rising rates will have a dire effect on bonds and many equity strategies as well.

• **Management team** -- Track records can be impressive but are irrelevant if the primary manager has departed.

Money-management firms are managed by people, not machines. A loss of a key portfolio manager may be a legitimate reason to look elsewhere.

New managers almost always will put their own brand on the product and generally, with most strategies, there's no reason to be a guinea pig for a new manager. Occasionally, the change is for the better, but regardless, it's rare that a new manager's strategy, with little or no history, fits in a total portfolio.

• **Ownership** -- Change of ownership can be a negative. Often the manager-owners realize a liquidity event that can douse that fire in the belly. In other words, they have just cashed in, and the manager's financial motivation suffers.

Additionally, the new firm's culture can be negative and often causes key personnel departures.

Ownership changes must be monitored closely, and in most cases, if ownership has just changed hands and the product is being considered, choose another.

Every strategy and firm will have weaknesses. The due-diligence and portfolio-construction process should identify where a strategy, manager and firm break down.

The key is that each product's rough periods should be rare and occur when other products, strategies and managers in the total portfolio are performing well.

Innovest Portfolio Solutions LLC provides investment consulting services to retirement plans, foundations, endowments and wealthy individuals. We can be reached at (303) 694-1900.
Rich Todd can be emailed at richt@innovestinc.com