

What Makes a Good Fund Picker?

Litman Gregory has been conducting intensive due diligence on mutual funds for over 30 years. We not only have a deep, experienced analyst team, but also unmatched access to portfolio managers across asset classes. A subscription to AdvisorIntelligence includes the full suite of fund research we produce to inform the portfolios we manage for our own asset management clients. Below, Litman Gregory senior research analyst and principal Jack Chee discusses our mutual fund due diligence process in more detail and describes the value of outsourcing manager due diligence to a proven fund picker.

A Conversation with Litman Gregory's Jack Chee

STEP 1: IDEA GENERATION AND PERFORMANCE ANALYSIS

Many investors screen on performance to identify new funds, despite the evidence that shows past performance is not predictive of future returns. How do you begin your search?

Some of us on our team have been in this industry for upwards of 20 years, so we have a network of contacts and relationships with both the managers themselves and on the sales and marketing side, which helps us find new ideas. We also read industry publications and websites to stay on top of opportunities. So we have a lot of different ways of trying to dig up new ideas.

We still often begin by screening for funds with compelling long-term track records—the longer the better. But we are willing to look at funds with shorter track records, and intentionally runs screens for them, especially in the capacity-constrained small-cap space where successful managers may close their strategies to new investors before a long-term track record can be established. Of course, we raise our qualitative due diligence bar even higher when we have less history and information.

Past performance is useful only as a tool for screening funds to identify those worthy of further research. We believe it's more important to identify why a fund performed well in the past, determine if the portfolio management team has an identifiable edge (i.e., was past performance due to luck or skill?), and assess whether the edge is sustainable. To answer these questions requires intensive firsthand contact with fund managers and their research teams, which most advisors are unable to achieve on their own due to resource constraints and limited access.

As you move beyond performance and try to gain clues about how a manager runs money, what do you find are the most useful sources of insight into a manager?

The next step is to try to identify what drove the strong track record. When looking at performance, we might get the sense that the manager wins by losing less in down markets, or, conversely, outperforming meaningfully in strong markets. We look at the number of holdings, the concentration or percentage of assets in the largest portfolio holdings, industry concentrations over time, cash levels, etc. There are also shareholder-oriented metrics, such as fund expenses, whether the fund family has a history of closing other funds at responsible levels, and whether



the fund family pushes managers to run additional products.

What we find most useful are historical monthly or quarterly fund commentaries from the manager, going as far back as possible. Commentaries can offer useful insights into a manager's philosophy, how they run a portfolio, and what they were thinking and how they structured the portfolio over different market cycles. We also try to dig up interviews the managers have done in the press.

If a manager's commentaries include monthly buys and sells, we build spreadsheets that track portfolio trades for years. This exercise has provided many insights into managers' processes. It allows us to observe the typical holding period of their picks, the percentage of winners and losers in the portfolio over time, and the magnitude of the contribution to performance, either up or down.

STEP 2: IN-DEPTH DUE DILIGENCE

Your process depends heavily on your personal interactions with managers and their teams, including repeated interviews and site visits. What are some of the things you're trying to uncover in your conversations with managers?

Being armed with information is key when conducting manager due diligence. Running through a generic checklist of questions during an interview will not lead to success. Simply asking a manager about a mistake doesn't work because not only has the manager been asked that question a hundred times, they will often take it a step further and spin their response in a way that makes it look as though it wasn't their fault. Their job is to assuage any concerns shareholders may have about their investment process. For this reason, I think it's critical to steer the conversation. We approach due diligence through the lens of what doesn't the manager want us to find out. This requires that we be intentional about what we are trying to get at, and how we are asking the questions.

Every fund manager will tell you that they have "a disciplined and repeatable" approach. We can't just accept that. Our job is to understand how managers think and how they make decisions. Inevitably, every manager will underperform for some period of time, sometimes meaningfully. Unless you deeply understand the discipline of their investment process, when the underperformance happens you will be left guessing whether to stick with the fund or sell. What differentiates Litman Gregory's approach is that by understanding why the underperformance is happening, we can surgically dig into mistakes and confidently assess whether a manager's investment process is breaking down.

Is it important to meet with members of the team other than the lead manager?

We spend most of our time initially with portfolio managers because we want to understand their roadmap, but we always speak with their analysts as well. We want to gain confidence that the entire team is following that roadmap. If the analysts aren't researching companies in a way that's consistent with the process that the managers have explained, that can lead to a breakdown in our confidence. We also meet with firm management to understand the direction they want to take the firm. Every firm has to make a decision at some point as to whether they want to be performance oriented or asset oriented. We might also talk to the traders, former clients, former co-workers, former co-portfolio managers, and former analysts as a way to verify our findings. We don't take a cookie cutter approach to manager due diligence. Our approach will be specific to that manager and what we feel is important to their process. The goal of our initial conversations is to, as quickly as possible, figure out if an edge does exist. More often than not, we identify an edge pretty quickly. If not, research stops in the early innings.

STEP 3. RESEARCH TEAM VETTING

At what stage do you bring in the rest of the Litman Gregory analyst team?

We have a preliminary team vetting when we feel reasonably confident that an edge exists and that we have done some verifying or stress testing of the components we think make up that edge. Our internal team vetting sessions can last for hours. The primary and secondary analysts researching the fund will lay out everything they know

about the manager's process: what they like, their concerns, areas for follow-up, an explanation of performance, and obviously the edge. The other analysts will then play devil's advocate by asking questions and trying to shoot holes in the research. After this preliminary team vetting, we continue our conversations with the manager and analysts. That can involve another site visit or several more phone calls. Then once we feel we've covered everything, we'll do a formal team review.

The vetting process is always a team-oriented approach. When we conduct research on funds, we record the conversations we have with managers and get them transcribed so any of the analysts playing devil's advocate can listen to the conversation or read a transcript to become deeply informed. They can then challenge and question the primary analysts. It allows for better discussions. If the investment thesis can't stand on its own legs, it'll come out in the vetting process.

STEP 4: CONTINUOUS MONITORING

How do you monitor the funds, once they're on your Recommended List and/or in the model portfolios you offer on AdvisorIntelligence?

We get a scorecard every day in terms of managers' performance relative to the benchmark. Of course, we're long-term investors; a day, a month, or even a quarter doesn't indicate success or failure. What's important to us is that the investment discipline remains intact. So monitoring the manager is critical. That's as important as the initial due diligence. We verify this through conference calls, monthly and quarterly commentaries, semiannual and annual reports, performance, and, most importantly, constant contact with our managers throughout the year.

We're also paying attention to what they buy and whether we think it fits their process. In terms of what they sell, we might observe a significant loss. We'll note that down and make sure we talk about it the next time we speak to them. Anything we see that doesn't seem consistent with the discipline will be a topic of discussion. But if something happens at the firm or team level that we consider material, we call them immediately.

If you start to see the same patterns repeat over time, that's when we push really hard. The leash gets shorter. We challenge more. The same with performance—the longer the period of underperformance, the shorter the leash gets.

BRINGING IT ALL TOGETHER

How can advisors really conduct this level of analysis?

The truth is, they can't. They're not going to get the access, and it's not their sole job, either. They're meeting with clients and prospects, managing client portfolios, running the other aspects of their business.

We can spend 40 hours talking to a manager, and that's not even counting the analyst team, co-managers, and other people at the firm. Not only are we talking to managers and their teams for hours, but we're also in our offices around a table for hours marking up whiteboards, trying to really help us understand what it is that we truly like about this manager. What could go wrong? If person A leaves, what does that mean to our opinion?

Also working in our favor is that we have a really broad reach through our products and the assets we manage. So firms want to talk to us and are willing to give us a lot of time. I think the amount of upfront work that we do helps us gain access to managers. We often get e-mails or comments from managers that say, "That was a really interesting conversation; I would love to have more of these, because I never even touched the pitch book." Or, "Man! That was a lot! I've never been asked those questions before." I don't mention that to be egotistical. It's just that we love doing this piece of it. We love manager due diligence, and it's a big part of what we do.

So when Jack Bogle of Vanguard says finding an active manager that can outperform is like finding a needle in a haystack for most investors, I would agree. That's why the value of service like AdvisorIntelligence is huge for advisors. They can leave the quantitative and qualitative manager due diligence to an expert consultant they trust and focus on their business.

How does your work support advisors in fulfilling their fiduciary duty to clients?

Many advisors are feeling pressure to provide concrete justification for paying an active manager's fee. Many have settled for purely passive investment vehicles to protect themselves against legal liability, even when they believe (as we do) that it is possible to identify active managers who can consistently outperform. This is exactly what our work has always been about. If we don't have confidence that an active manager will outperform a passive benchmark over a full market cycle, we won't invest our clients' money with them and we won't recommend it to other advisors either. Performing deep due diligence on any recommended strategy is a best business practice we've followed at Litman Gregory since our founding in 1987. Our service allows AdvisorIntelligence subscribers to outsource their active fund selection to us with the confidence that comes from aligning with a firm that has acted in their clients' fiduciary interest since day one.

Want to learn more about our AdvisorIntelligence service?



925 254-8999



research@advisorintelligence.com



www.advisorintelligence.com