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Games That Managers Play

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In evaluating a money manager, informed investors naturally want to evaluate the manager's track record. Has the manager delivered returns above the chosen benchmark? Have they assumed excessive risk in order to achieve those returns? What about the impact of fees and taxes? How reliable is the performance data provided by less-regulated private fund managers? These are just a sample of questions that investors should answer in order to validate a manager's competence, and the answers are rarely clear-cut.

Even in the highly-regulated and researched world of public mutual funds, investors need to be aware of certain factors that inhibit an objective evaluation. Mutual fund research firms such as Morningstar and Lipper aggregate funds with like characteristics together to create "peer comparisons", but often time they disagree on the appropriate peers. For example, Morningstar may list a fund as US Growth while Lipper may decide that US Core is more appropriate. The selection of an appropriate peer group can be critical in determining a fund's relative success, and managers may contort their portfolios to be included in a peer group which puts them in the best light.

The assigned benchmarks from the fund's managers may have characteristics that are significantly different from the fund itself. An example might be an emerging markets equity fund that limits itself to a subset of EM countries or regions, while the benchmark includes countries that are outside of the fund's approved investment universe. Lists of top performing funds published in newspaper such as the New York Times and the Wall Street Journal rarely draw attention to these measurement differences and usually provide little information on the risk level of funds in a given category. Even with all these caveats, published results are by definition backward-looking, and studies have shown their predictive power is questionable.

In short, the assignment of a single rating (e.g. "5 stars") is rarely enough to draw firm conclusions about a manager's ability to exceed a benchmark or outperform her competitors.

In the world of private investments such as hedge funds and private equity, apples-to-apples comparisons are even harder to make. Light regulation in this area invites some dubious practices. In a study published several years ago, the researchers found that a whopping 77% of private equity managers claimed top-quartile performance by manipulating valuations, performance, or benchmarks[1].

Among the many legal techniques that private fund managers use to validate their skill are:

- Choosing time periods that produce the highest compounded returns or that eliminate periods of underperformance;

[1] *Phalippou, Ludovic, and Oliver Gottschalg, "The Performance of Private Equity Funds", Review of Financial Studies, vol. 22. no. 4 (April 2009)*

- Selecting benchmarks that are not representative of the type of strategy the manager is pursuing;
- Providing total (not annualized) returns over long time periods which gives the impression of outstanding results when the annualized return might be quite modest;
- Adopting deceptive fund names to understate the fund's risk level;
- Comparing themselves to managers with lower risk profiles;
- Utilizing questionable valuation methodologies not confirmed by independent audit;
- Cobbling together a track record by combining returns from simulations, prior history from a previous employer, and/or personal account returns;
- Forecasting aggressive returns on investments to be realized far into the future;
- Ignoring the impact of taxes (particularly meaningful for taxable investors utilizing hedge funds).

As evaluators of external private fund managers, Ballentine Partners insists on complete transparency of performance information provided. We triangulate information from multiple sources to verify accuracy. We perform operational due diligence by reviewing the manager's internal controls, performance calculation and valuation methodologies, and by interviewing the manager's external service providers. And we don't invest until we are convinced that the manager's integrity and professionalism are beyond reproach.

While none of these procedures can ensure success, we are confident they minimize the likelihood of a significant mistake. Being aware of the games that managers play may be enough to stand out above the crowd.

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In addition to working directly with a number of family clients, Bruce serves on the Investment Management Committee, which is responsible for the oversight of all of the investment activities for the firm. Bruce rejoined Ballentine Partners in June 2016 as Managing Director and Director of Portfolio Research after more than 5 years as Chief Investment Officer of City National Rochdale, LLC, in Los Angeles. City National Rochdale, a wholly owned subsidiary of City National Bank, serves family clients across the United States with a staff of nearly 100 investment professionals. Before moving to Los Angeles, Bruce served as Chief Investment Officer of Ballentine in our Waltham office for three years. Prior to that, Bruce spent four years with Morgan Stanley Private Wealth Management in New York and eight years with Glenmede Trust in Philadelphia as Chief Investment Officer and Portfolio Manager. Bruce received an MBA with a concentration in Applied Economics from George Washington University and a BS degree in Business Administration from Penn State University. Bruce holds the Chartered Financial Analyst (CFA) and the Certified Private Wealth Advisor (CPWA®) designations. He lives with his wife in Palm Beach Gardens, Florida.