Banyan Capital Management

Are All Money Managers Created Equal?

by Gary L. Watkins, President
Banyan Capital Management, Inc.

Investing in equities is a substantial undertaking that requires knowledge, experience and a significant time commitment in order to achieve success over the long term. An enormous amount of information must be reviewed and evaluated continuously. Detailed financial analysis must be performed accurately and consistently. Independent research must be conducted to augment and verify published information. For these reasons and others, it may be wise to enlist the services of a professional money manager.

What Does A Money Manager Do?

The first step in selecting a money manager is to gain an understanding of the services typically provided by a professional money manager. These services should generally include the following:

- Drafting a statement of investment policy to set forth:
  - *Initial asset allocations*
  - *Performance objectives*
  - *Limits to be invested in any one company or industry.*
- Evaluating business, economic and legislative developments and their affect on the portfolio
- Engaging in continuous securities analysis
- Providing regular written reports showing the configuration of the portfolio and its performance
- Managing the administrative process with the custodian of the portfolio

In addition to the services outlined above, a good money manager will provide superior client service customized to meet the needs of the investor's portfolio. After establishing the basic level of service provided, it is important to determine whether a particular money manager is a good choice for the investor. This can be accomplished through one or more personal meetings in which several critical areas are evaluated.

Investment Philosophy

One of the most important areas to evaluate is the investment philosophy of the manager. Is their strategy understandable and one that seems likely to provide for long-term investment success? Are they concerned with absolute returns and what can potentially go wrong with an investment, or are they more concerned with relative performance? An investor, whose primary concern is outperforming an index, is likely to build a portfolio shadowing the components of the index. This approach would lead to overweighting or underweighting index components. Regardless of how overvalued or undervalued a particular security might be, such an investor would keep the percentage of a portfolio dedicated to each security fairly close to its weighting in the index. This approach does not reflect a thoughtful attempt to evaluate the investment merits of the underlying companies.

Personal Ethics

A key area for investigation is personal ethics. Does the potential money manager invest his/her own money in the same companies as those selected for client investments? This is a true indication of a manager's integrity, confidence in his or her own investment approach, and ultimately the likelihood of investment success.

Fair Treatment of Clients

Another area to investigate is whether clients are treated fairly. Are all of the money manager's clients treated equally? If they aren't, why not, and in what ways are they treated differently? For example, are transactions performed for all clients at the same time? If they aren't, what method is used to ensure fairness? A good money manager will have detailed answers to these questions and established operating procedures to treat all clients fairly.

Performance

Scrutinizing the past performance of those under consideration is essential. First, determine if the manager utilizes the Chartered Financial Analyst (CFA) Institute (formerly AIMR) Standards for calculating and reporting performance. Though the guidelines are not perfect, they serve as a fair representation and provide full disclosure of performance results.

Secondarily, use of the CFA Institute Standards provides for greater uniformity and comparability among performance presentations of investment practitioners. Next, inquire about the length of time included in their published performance record. Anyone will be able to emphasize some period of good performance during the course of their investing history. It is important for the investor to understand the duration of the record. Is the person whose performance the investor is reviewing the one that will actually manage the portfolio? Also, did the reporting period span one or more economic or market cycles and have good results been achieved steadily over the long term or are they based on a couple of successes. Are they still doing what has made them successful in the past? The answers to all of these questions are critical to understand real performance and to compare performance records among potential managers.

Risk

Returns should always be viewed in light of the level of risk involved. There are several types of risk associated with investing in the stock market besides the obvious risk of a general market decline. Some of these risks include regulatory, inflationary, currency, interest-rate, credit risk, the increased volatility associated with companies that are heavily followed by 'the street' and the risk of the general economic cycle. A good money manager will have a solid understanding of these risks and take them into consideration when investing to meet an investor's objectives.

While a manager with poor long-term results is certainly not a good choice to handle an investor's portfolio, neither should an investor automatically choose one simply because they have the best recent performance. A few of the questions which will provide for a comparison of the risk level associated with a performance period are: was the manager fully invested at all times? Did the manager achieve good results despite having held substantial amounts of cash and cash equivalents, possibly indicating a low-risk approach? Were the investments in the underlying portfolio themselves particularly risky, or did the manager reduce risk by holding cash, hedging, using arbitrage, or some other method?

Errors

Money managers make mistakes from time to time. In the interview process, ask the manager to enumerate previous investment mistakes. Those asserting that they've made no mistakes should be further evaluated. If they have made no mistakes, they likely have not been investing for any length of time. When discussing a manager's mistakes, ask what was learned from the experiences and how they are doing things differently today as a result. It is important to note that different investment approaches go into and out of favor. If a manager with a good long-term record has a poor recent one, perhaps they are specializing in an area that is temporarily out of favor. If so, it is possible that as the cycle turns the results could return to their long-term mean. Consequently, a period of relatively poor performance could certainly be followed by several strong years.

Compatibility

Finally, the investor should look for a financial professional with whom they are compatible. The development of a solid relationship depends partially upon personal rapport, combined with an investment approach with which you can be comfortable. A conservative investor may not feel comfortable with a professional short seller regardless of the returns he experiences, just as an aggressive investor may not be compatible with a manager who buys and holds securities for the long term.

Summary

If you have touched on each of these points and hired a money manager—congratulations. The chance of having a successful investment experience has been elevated substantially. Keep in mind that it may require several years for a new portfolio to sprout and bear fruit. Accordingly, allow for ample time to be effective while ensuring that results are reasonably in line with the market environment.

How Banyan Capital Management Addresses These Issues

Investment Philosophy

The value approach used at Banyan is a time-tested success. Following the value path leads to generous returns in all but the most speculative of up markets. More importantly, your capital is better protected during difficult market periods. After a careful look at our equity composite performance, you will see that our approach has withstood the test of time.

Personal Ethics

Banyan Capital Management's employees are prohibited from making equity investments in securities other than those alongside our clients.

Fair Treatment of Clients

We strive to treat all our clients equally and fairly. When executing trades on our clients' behalf we often use methods such as block trading to ensure that no client is at a disadvantage due to the timing of a transaction. We also strive to keep transaction costs to a minimum. Our seasoned portfolios typically experience transaction costs of less than one-tenth of one percent annually.

Performance

Banyan's equity performance presentation is not in compliance with the standards established by the CFA Institute. While we embrace the concept of a single standard for the industry, for practical reasons, we have chosen not to guarantee adherence to each and every provision of this ever-changing yardstick. Even if we believed we are compliant with the standards, we would not claim that we are CFA Institute compliant.

While some managers may report performance data only on their best, biggest or surviving clients, our practice is to include all client relationships for every reporting period. Client portfolios are invested in the same securities with only minor variations.

Risk

Banyan Capital Management works diligently to minimize risk in our investment process while still providing for solid upside potential. We manage risk one security at a time through buying those securities that we appraise to be worth more than what we are paying. We also limit our investing to a relatively small number of securities, avoiding the risk associated with over-diversification. When we are not able to find enough stocks to meet our strict investment criteria, we control risk by remaining in cash or engaging in arbitrage. We continue to improve at assessing risk and we are committed to becoming even more skilled in the future.

Errors

Any process based on evaluation and judgment is subject to occasional error. Investing is no exception. We acknowledge our past mistakes, which have primarily related to missed opportunities. We are absolutely committed, however, to learn from the oversights of the past so as to continue to improve at what we do.

BANYAN CAPITAL MANAGEMENT, INC.
2100 RIVEREDGE PARKWAY • SUITE 1030 • ATLANTA, GA 30328
PHONE 770.951.2129 • FAX 770.951.8277
www.banyancapital.com