

## THE PRACTICAL PORTFOLIO

# How We Choose Portfolio Managers

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## Suppose you want to add more large-cap stock exposure to your portfolio, and you are evaluating a number of actively managed mutual funds. How do you choose the right fund?

Most people will compare the recent performance of funds, or they will look at a fund's rating, such as its Morningstar rating. Unfortunately, choosing investments based on past performance or ratings is often ineffective. Dalbar, a research firm that studies how investors typically behave, has consistently found that investors make flawed investment choices, often connected to their urge to act based on past performance\*. In other words, the typical investor has a limited understanding of performance drivers and how those translate to a fund's future prospects.

### How We Select Active Managers

Active management can be the most valuable when it's a long-term choice: You have to hold a particular investment through a full market cycle to assess and reap benefit from a manager's decisions. With that as a backdrop, we evaluate active managers based on a range of characteristics:

#### Qualitative:

- The talent and continuity of the management team
- The rationale underpinning the fund's investment strategy
- The decision-making process for buys and sells
- The compensation incentives for managers

#### Quantitative:

- Long-term track record
- Performance in both up and down markets
- Risk profile

### A Preference for Downside Protection

Investors dislike losses more than they enjoy gains. Large losses during volatile markets can shake investor confidence and lead to misguided attempts to time the markets. And remember, the larger the loss, the greater the return required to get back to even. Therefore, we try to keep pace with the market in up markets and minimize losses for clients in down markets.

When we evaluate managers, we search for those with demonstrated track records of delivering strong risk-adjusted returns across full cycles. We believe that an investor can outperform with less risk over the long term by mitigating losses during market sell-offs. We also look beyond standard performance to clues about a fund's likely behavior: For example, upside/downside, capture, style tilts, and concentration patterns are all useful inputs in that evaluation. In sum, we try to select managers who can outperform over the long run with less risk. This helps our investors stay invested through volatile market cycles.

### WHAT IS ACTIVE MANAGEMENT?

Portfolios can be managed passively or actively.

#### PASSIVE PORTFOLIOS

**A passive portfolio is one that simply aims to mimic the performance of an index, such as the S&P 500, which means limited buying and selling.** An active portfolio is one where the managers are actively choosing particular stocks or bonds, buying and selling when they feel the trades are most opportune.

#### ACTIVE PORTFOLIOS

**A truly active portfolio, therefore, is one that is not identical to its benchmark. It can differ in a number of ways:**

- Sector weights or factor weights
- The concentration of individual positions
- Ownership of out-of-benchmark securities
- Active trades month-to-month

\*<https://www.nytimes.com/2019/07/26/your-money/stock-bond-investing.html>

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