AMI INVESTMENT MANAGEMENT
Registered Investment Advisor

White Paper

A Framework for Analyzing Investment Advisors

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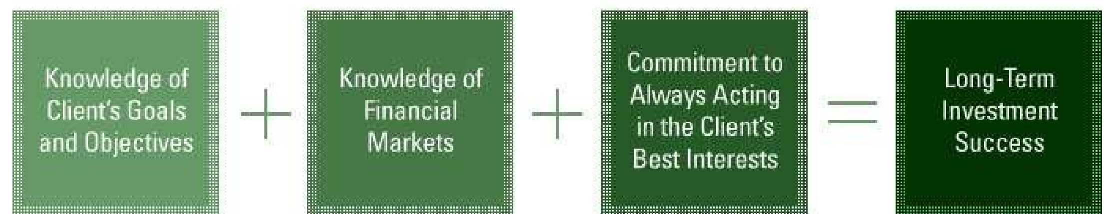
The selection of an investment advisor can be a difficult task. Investors are faced with the challenge of judging the merit of an advisor based on an incomplete picture of relevant information and sometimes unfamiliarity with the investment industry. Potential conflicts of interest between advisor and client may hamper investment results. Qualitative assessments, though hard to perform, are necessary to an informed decision. A review of advisors' policies and practices goes a long way towards identifying top fiduciaries. When investors can conduct such qualitative and policy reviews under a logical and consistent framework, the odds of success increase dramatically.

A Framework for Evaluating Investment Advisors
Long-term investment success can be broken down into three key components:



1. *Knowledge of the client's goals and objectives* – Investment solutions are not a one-size-fits-all service. Different clients possess different goals and objectives. In order to provide an investment solution optimal for the given client, the investment advisor must have an intimate understanding of that client's unique circumstances.
2. *Knowledge of financial markets* – To provide intelligent, appropriate investment options for clients, investment advisors must have knowledge of investment markets.
3. *Commitment to always acting in the client's best interests* – An investment advisor could possess both a proper understanding of the client's goal and objectives and knowledge of financial markets but still engage in behavior detrimental to long-term success because of inefficient incentive mechanisms or issues of integrity.

If a client can confidently gauge an investment manager's competence within each component of the framework outlined above, then he or she has gone a long way towards identifying a value-added relationship with strong odds of producing attractive long-term results. Investment managers that successfully operate across the entire framework typically possess several key traits, including intelligence, passion for the field and integrity.

A satisfactory examination requires qualitative assessments. Depending on their own personal experiences and relationship with the investment advisor, clients may find such tasks difficult or easy to implement. There exist some objective, straightforward considerations that can go a long way towards providing the information necessary to make an informed decision though.

Knowledge of the Client's Goals and Objectives
Understanding a client's goals and objectives requires, above all, quality communication between the client and the investment advisor. The client's properly identified goals depend upon the investment time horizon, the purpose of the investment assets, unique circumstances such as tax status and the existence of external assets and other factors. Importantly, discussions must include an in-depth conversation about risk tolerance – not only how much risk the client is *able* to take but also how much risk the client is *comfortable* taking.

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Clients likely have an idea of whether their investment advisor has a thorough understanding of their goals and objectives. Quality relationships usually consist of regular meetings and discussions. They also require an effort on the part of the investment advisor to communicate portfolio strategies and investment research in an understandable manner so that the client can be an integral part of the investment process. The standard of success typically mandates working with a concentrated client base.

> While routine communication might be conducted through broad-based mailings or by client service personnel, informed clients inevitably require meaningful amounts of an investment principal's time and energy. An investment adviser opting for less involved, less burdensome clients makes a potentially serious mistake. First, high-quality clients occasionally provide useful input into the investment process. Second, in the event that the firm experiences an explicable stretch of poor performance, well-informed clients tend to continue to support the manager's activities.[1]

It is also appropriate for clients to demand a quality service experience from their investment advisors. Investment assets exist for the benefit of their owners and clients should have a positive experience working with client service representatives at their advisor's firm.

Knowledge of Financial Markets

It seems obvious that knowledge of financial markets is an important factor to long-term investment success, although objectively judging such intelligence can be a difficult endeavor. Various approaches to investment management exist that all may possess some merit. But while opinions on proper investment management practices differ, a few core concepts appear fundamental to any intelligent investment program. Warren Buffett identified three *key failures* that have historically caused investors to experience lackluster results:

- *High costs, typically as a result of excessive turnover and overpriced investment products.*
  Portfolio costs are greater than just the fees paid to investment managers and include commissions, taxes and other costs. While such costs are a necessary byproduct of investment management, too often advisors let such costs rise to inexplicable levels, leading to a dangerous handicap relative to the market. For instance, the frequent turnover of investment positions creates high commission costs and the recognition of capital gains without providing much benefit to investors. We typically view such behavior as irrational and detrimental to long-term returns. Long-term holding strategies typically outperform strategies employing heavy portfolio turnover.[2] Studies have shown that the performance records of high-cost portfolio strategies and investment products typically do not justify their fees.[3] Top advisors manage tax-efficient, cost-conscious portfolios.

  > In an industry characterized by a long litany of shockingly dysfunctional behaviors, the frenetic churning of mutual-fund portfolios stands near the top of the list. In 2002, the weighted-average turnover of equity mutual-fund portfolios registered at a staggering 67 percent…Frequent trading of mutual-fund portfolios takes a toll on investors ranging from easy-to-measure commission costs to difficult-to-assess market impact costs to impossible-to-defend tax consequences. Rapid portfolio turnover proves inconsistent both with strategy for investment success and with fidelity to fiduciary responsibility.[4]

- *Investment decisions based on "tips and fads rather than on thoughtful, quantified evaluation of businesses."*
  Wall Street is a competitive place and superior investment results require unconventional insight. Intelligent investment practices are based on the careful analysis of individual businesses. Investment advisors too often focus on macroeconomic factors and trends that have little predictive value for long-term investment results.

  Fundamental, bottom-up analysis of individual businesses provides observable, actionable data not biased by tips or fads. Valuation, the measure of a business' true worth based upon its cash flows and assets, is the key variable to predicting long-term returns.

  > When investing, we view ourselves as business analysts – not as market analysts, not as macroeconomic analysts, and not even as security analysts.[5]

  Unconventional insight requires independence in thought. Wall Street is full of salesman often trying to push products or services. Accordingly, published research is often biased. Wall Street analysts and investors have a tendency to herd, lining

[1] Swensen, David. *Pioneering Portfolio Management*. New York: The Free Press, 2000.
[2] Warren Buffett once said, "If you don't feel comfortable owning something for 10 years, then don't own it for 10 minutes."
[3] For instance, a Morningstar study evaluating mutual fund performance and fees recently concluded, "How often did it pay to heed expense ratios? Every time…Expense ratios are strong predictors of performance. In every asset class over every time period, the cheapest quintile produced higher total returns than the most expensive quintile." Kinnel, Russel. *How Expense Ratios and Star Ratings Predict Success*. Morningstar, 2010.
[4] Swensen, David. *Unconventional Success*. New York: The Free Press, 2005.
[5] Buffett, Warren. Berkshire Hathaway Annual Letter to Shareholders, February 29, 1988. *Berkshire Hathaway 1987 Annual Report*. Omaha, NE.

up behind crowded trades and producing financial bubbles. Going against the crowd can be difficult and requires investor fortitude. As British economist John Maynard Keynes said, it is often easier to fail conventionally than to succeed unconventionally. But investment success and proper risk management require unique analysis and independent thought.

> There are two requirements for success in Wall Street. One, you have to think correctly; and secondly, you have to think independently.[6]

- *A "start-and-stop approach to the market marked by untimely entries and exits."*
  History has shown that trying to time markets – to buy and sell securities based on short-term market and economic forecasts – is typically a futile endeavor. Investors often sell when prices are low and buy when prices are high, a poor program for investment success. Successful investors focus on long-term holding periods and think of stocks as businesses, not pieces of paper. Disciplined investment management programs stay true to long-term asset allocation targets, deviating from their strategic investment policies only when markets present undeniably attractive contrarian value (or as Buffett says, if investors "insist on trying to time their participation in equities, they should try to be fearful when others are greedy and greedy only when others are fearful"[7]).

> We've long felt that the only value of stock forecasters is to make fortune tellers look good. Even now, Charlie and I continue to believe that short-term market forecasts are poison and should be kept locked up in a safe place, away from children and also from grown-ups who behave in the market like children.[8]

> In 75% of those years [past 44-year period], the S&P stocks recorded a gain. I would guess that a roughly similar percentage of years will be positive in the next 44. But neither Charlie Munger, my partner in running Berkshire, nor I can predict the winning and losing years in advance. (In our usual opinionated view, we don't think anyone else can either.) We're certain, for example, that the economy will be in shambles throughout 2009 – and, for that matter, probably well beyond – but that conclusion does not tell us whether the stock market will rise or fall.[9]

It should be noted that the depth of investment knowledge is only important up to a critical point – after that, as long as the investment advisor stays within his circle of competence (what he understands), he can find enough opportunities to produce superior investment results. It is when an investor strays outside his or her circle of competence that excessive risk materializes.

> If we [Berkshire Hathaway] have a strength, it is in recognizing when we are operating well within our circle of competence and when we are approaching the perimeter.[10]

We would also note that experience, education and certification can be useful inputs when evaluating advisor competence, but must be judged objectively and critically. Not all experience is equal and the quality of educational programs varies widely. Nearly all investment advisors possess some kind of certification, so understanding what a specific certification entails is required in order to make such information useful to advisor analysis.[11]

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Finally, successful investment advisors possess a deep passion for the field. Investment analysis requires continual learning and ongoing analysis of a large amount of new information. The best advisors view research and analysis as a passion more than a job.

> Personal characteristics play an enormous role in determining which of the market players prevail. Great investment managers pursue the business with a passion bordering on obsession. The most successful practitioners sometimes marvel that they are paid to practice such an intellectually stimulating profession. Because the range of influences on markets defies

[6] Benjamin Graham from interview with Hartman L. Butler, Jr. in Zweig, Jason. *Benjamin Graham: Building a Profession*. McGraw-Hill: 2010.
[7] Buffett, Warren. Berkshire Hathaway Annual Letter to Shareholders, February 28, 2005. *Berkshire Hathaway 2004 Annual Report*. Omaha, NE.
[8] Buffett, Warren. Berkshire Hathaway Annual Letter to Shareholders, March 1, 1993. *Berkshire Hathaway 1992 Annual Report*. Omaha, NE.
[9] Buffett, Warren. Berkshire Hathaway Annual Letter to Shareholders, February 27, 2009. *Berkshire Hathaway 2008 Annual Report*. Omaha, NE.
[10] Buffett, Warren. Berkshire Hathaway Annual Letter to Shareholders, March 1, 2000. *Berkshire Hathaway 1999 Annual Report*. Omaha, NE.
[11] At the risk of biasness, we highlight the Chartered Financial Analyst (CFA) designation. The idea for the CFA originated with Benjamin Graham, Buffett's mentor and teacher, who desired to create a professional certification to place the field of financial analysis on par with "fields of accounting, law, medicine and other professions." The designation is difficult to obtain and covers a wide variety of subjects, including ethics, accounting, economics and statistics in addition to finance and investments. Author and journalist Jason Zweig writes, "The Chartered Financial Analyst designation is the gold standard of intellectual rigor and ethical conduct in security analysis." Zweig, Jason. *Benjamin Graham: Building a Profession*. McGraw-Hill: 2010.

> description, nearly every aspect of life provides gist for the investment manager's mill. Active managers who allow the markets to permeate their lives enjoy a greater likelihood of investment success.[12]

Commitment to Always Acting in the Client's Best Interests
Integrity is the most important factor to consider when selecting an investment advisor. It ensures that the advisor will act in the best interest of the client and usually involves a strong work ethic that guides the advisor to tirelessly search for attractive investment opportunities. Top advisors manage client funds as if they were their own. There exist enough examples over the past market cycle of the perils of working with unethical investment managers. Investors that ignore integrity as a key factor to investment success make a potentially serious mistake.

> Real estate investors invoke the mantra "location, location, location." Investors seeking to engage an active manager should focus on "people, people, people." Nothing matters more than working with high-quality partners. Integrity tops the list of qualifications. Aside from the powerful fact that moral behavior defines a fundamentally important standard, acting in an ethical manner represents a pragmatic means of improving the probability of investment success. Choosing external advisers of high integrity reduces the gap between the actions of the advisers and the interests of [the client]...In a world rich with alternatives, compromising on structural issues makes little sense. Attractive investment management organizations encourage decisions directed toward creating investment returns, not toward generating fee income for the manager.[13]

Judging integrity may require a close personal relationship with an individual. Other aspects of an investment advisor give clues to their willingness to act in the client's best interests:

- *The investment advisor is committed to transparency and communication.*
  Investment managers should treat their clients as they themselves would want to be treated. This includes disclosing the information necessary to understand the investment process. Reports should include a detailed list of investments sorted by type, fees paid by the client for portfolio management services, performance versus a relevant benchmark and commentary on portfolio strategy. Advisors must show the ability and willingness to explain and justify their portfolio management practices.

- *The investment firm is independent, small, and entrepreneurial.*
  When investment advisors have a meaningful ownership in their organization, they typically work with a passion to defend and enhance the firm's reputation. Small, independent organizations have more flexibility in enacting investment decisions, avoiding bureaucratic and organizational impediments. They are not constrained to a certain set of investment products, instead seeking out investments that best suit the needs of their clients.

  > In selecting external managers, investors attempt to identify individuals committed to placing institutional goals ahead of personal self-interest. Alignment of interests occurs most frequently in independent investment management firms run in an entrepreneurial fashion by energetic, intelligent, ethical professionals…Small, independent firms reside at the opposite end of the spectrum from large subsidiaries of financial services conglomerates. Appropriate firm size and sensible ownership structures contribute to the probability of generating superior investment results. Moreover, the tendency of smaller, principal-oriented firms to behave in an entrepreneurial fashion provides critical context to the investment management process…By selecting investment managers with an entrepreneurial orientation, fiduciaries improve the chances for investment success. Large, multiproduct, process-driven financial services entities face the daunting hurdle of overcoming bureaucratic obstacles to creative decision making. Small, independent firms with excellent people focused on a well-defined market segment provide the highest likelihood of identifying the intelligent contrarian path necessary to achieving excellent investment results.[14]

- *The investment manager has the resources to satisfactorily fulfill his duties.*
  Successful investment management requires intense research and quality client communication. Advisors must have the time available to form strong client relationships and focus on their key value-added activities. Working with too many clients, spending an inordinate amount of time on business marketing or relegating investment research to a secondary concern can be a red flag for clients.

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[12] Swensen, David. *Unconventional Success*. New York: The Free Press, 2005.
[13] Swensen, David. *Pioneering Portfolio Management*. New York: The Free Press, 2000.
[14] Swensen, David. *Pioneering Portfolio Management*. New York: The Free Press, 2000.

- *The investment manager operates under an appropriately-aligned incentive structure.* Effective means of properly aligning investment advisor incentives with those of their clients include (a) "eating their own cooking" – investing in the same assets as their clients (subject to considerations of suitability) and (b) operating under sensible fee structures. Sensible fee structures, such as a flat fee charged on assets under management, incentivize the investment manager to maximize long-term performance. Inefficient fee structures can lead to portfolio activity detrimental to long-term investment success.

> Perhaps the most powerful incentive for an agent to serve client interests stems from substantial side-by-side investment. Co-investment places the agent [investment manager] on the same page as the principal [client], as the fact of co-investment actually transforms the agent into principal.[15]

Conclusion

The principles advocated above are not exhaustive and do not guarantee that an investment manager will exercise proper fiduciary standards. But they establish a set of factors that we believe go a long way toward ensuring that the investment manager will serve the interests of the client. Some factors should be non-negotiable; for others, managers may have defensible reasons for parting from practices discussed here, although we believe such reasons are rare. In any event, clients should expect advisors to be willing and able to address each point in full. Given the competitiveness of the investment markets, investors should not ignore issues of intelligence, commitment or integrity. We believe that the adoption of a framework such as the one discussed here could help promote more efficient and ethical behavior on the part of financial fiduciaries. It should also go a long way towards achieving satisfactory investment results for those who consider it.

[15] Swensen, David. *Unconventional Success*. New York: The Free Press, 2005.