Measuring the Value of Professional Portfolio Management

TRUXTON TRUST
A PRIVATE BANK

Derrick A. Jones, JD
Senior Managing Director,
Chief Fiduciary Officer
Wealth Management Services

Beverly H. Conley
Vice President,
Investment Operations Officer
Wealth Management Services

Connect With Us

615-515-1700

TruxtonTrust.com

Subscribe

Follow Us

When a family is seeking a professional to be a steward of their accumulated wealth, they oftentimes place a heavy emphasis on returns versus a benchmark. But competent portfolio management encompasses much more than just returns and there are underlying layers that are equally important. Some questions to ask are:

- How much risk will the manager take?
- Will the investment advisor try to push their company's proprietary products?
- Will my account look like everyone else's even though our situations are probably different?
- How will the manager pay attention to my tax situation?
- What about my dislikes of particular companies?

Investment Returns

A manager may produce stellar returns for a time, but it is important to peel back the covers to see what that return is made of and ask:

- Are there unnecessary risks taken to produce that return?
- How would the strategy perform in an extreme market correction such as that of 2007 to 2009?
- Would I be able to withstand such a fluctuation?
- Would it impact my lifestyle?
- Are the returns net of fees or gross?
- Do the returns warrant the fees associated with the management?

Consider a couple examples of how performance can be misevaluated. *Example 1:* Mrs. Jones is looking to move her accounts but only if the new firm can match the 7.5% yield she receives on her current portfolio. What Mrs. Jones may not realize is her portfolio has a nice yield but the value of her assets has decreased. She is mistakenly focusing on a **return on principal** and not a **return of principal**. *Example 2:* Mr. Smith enjoys meeting with his manager because the relative performance the manager demonstrates is always positive. What he does not realize is the manager is benchmarking his performance against a benchmark

that is not appropriate for the underlying portfolio. Investment returns matter but so do inflation, risks, taxes, and income needs.

Risk Management

How a manager values risk is an important consideration when evaluating an investment program. A manager should focus on the client and not beating a benchmark. It is important for a manager to keep risks in line with a client's lifestyle and what is appropriate given where the client is in life. When deciding on an allocation, a manager should ask: how would the client's lifestyle be impacted if there were a significant downturn in the securities market? In addition to the loss in value, what would the consequences be if dividends were slashed and securities had to be liquidated at depressed levels to meet the client's liquidity needs?

Tax Sensitivity

Another key consideration is the tax sensitivity of the manager. After-tax returns are what really matter. Finding a manager that is sensitive to a client's current tax situation is important. A manager should work with the client on keeping taxes in line with expectations and communicate if that is not the case. *Example:* Mr. Jones has sold a business and will have a big tax bill this year. In light of this information, his manager should be cautious with taking gains in his account and should look for ways to alleviate this tax burden by taking losses. Many investors invest primarily through mutual funds which often distribute capital gains at year-end even though the value of the client's investment may have gone down.

Ability to Customize

A manager should have the ability to customize based on client preferences and consideration of assets not under his or her care. Choosing a portfolio manager that takes a holistic approach to investing is important. Avoid someone that has tunnel vision and is only looking at what assets he or she is managing. *Example:* Mrs. Smith inherited a lot of General Electric stock from her father. A manager should be aware of this inheritance and not buy more in order to avoid increasing her exposure to this sector and company.

Beyond the Investments

Finally, it is important to look beyond the investments. No question that managing the portfolio is important but many other things can effect a family's balance sheet, income, and livelihood. Having a manager that can identify and affect those issues may add significant value to a client's financial well-being just as asset appreciation, dividends, and interest add value. *Example:* A husband and wife employ an investment firm to be a steward for their accumulated wealth, but the focus should not be solely on returns. The manager should also ask whether or not their clients have adequate life insurance, ascertain their clients' retirement goals, and offer to review their clients' estate plan, non-marketable assets, etc. Assessing the value of professional portfolio management should be multi-faceted. X% versus the S&P 500 is not an adequate measure, even if the variance is positive. ■