

Defining The Conflict Of Interest: Are Investors And Managers Fully Aligned?

Let's face it. The last six months have been miserable for investors, and even good investment managers haven't slept well recently. But, investors have learned much over the past year, and many now realize there is often an unnoticed, inherent conflict of interest between investor and money manager.

When times are good and the market is moving up at a steady pace, investors tend to become complacent and ignore many potential risks. When the market, however, turns down and things get tough, investors get scared and start to ask the questions they should have asked long before making their investment decisions.

To at least ensure greater protection moving forward, investors need to start asking a very key question: "Do you (the investment manager and/or employees) have the majority of your net worth invested in the fund where you want me to put my money?" The answer, of course, should be yes. Investors want and need to be in the same entity that the manager is using to calculate his/her composite returns.

Significant Co-Investment Makes A Difference:

Most managers who have had solid performance --and believe in their future risk adjusted return prospects --will have most of their own money in the fund that the investor is considering. This shows a commitment to the investment strategy and also makes sure the manager feels the "pinch" along with investors when times are tough. It also demonstrates a greater focus on risk management, as opposed to always swinging for the fences. Another potential benefit of this "alignment of interests" strategy is the incentive for the manager to focus on the tax consequences of trading and turnover ratios. For investors, it is after-tax returns that really matter.

Know Your Upside AND Downside Capture Ratios:

Another key metric for investors, which will give them a clear understanding of whether the manager has the shareholders' best interests in mind is the upside/downside Capture ratio. This ratio lets investors know how much real risk the manager is taking to generate returns. The higher the upside capture -the greater their returns; the lower the downside capture -the lower the losses and risk. Ideally, investors want to look for a combination of low downside capture along with high upside capture. The ratio gives the investor a powerful historical understanding of a fund's risk/reward profile. Investors should look at these metrics in the context of prior periods to see how they performed in different market environments.

Focus On Asymmetric Risk/Reward Ratios:

What has become all too common is that managers perform in line with an index or have wild swings. When markets are good, they outperform. And, when the markets turn negative they substantially underperform. This is an incomplete strategy. The focus should be on asymmetric risk/reward ratios in every type of investment. The best opportunities exist when securities are ignored or investors are too pessimistic about their potential. Some of the most viable investment opportunities exist when funds are able to purchase securities ignored by most investors. The idea of following the herd and chasing returns always catches up with managers and their investors. If anything, we're seeing that it pays to be a contrarian. A contrarian approach leads to attractive upside/downside capture ratios, which again, is an effective way to demonstrate risk adjusted returns.

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The opinions expressed are those of Harry Rady, Founder and CIO of Rady Asset Management LLC.



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Seek Long Term Track Records:

It is also important for a manager to have a long term track record. This truly demonstrates that the manager has experienced different market cycles and is not just getting lucky at a particular time in the cycle. In addition to the dynamic nature of changing markets, factors such as sell discipline, portfolio turnover and trading are best demonstrated through a lengthy and consistent track record.

Prioritize Ease Of Information:

While we can all appreciate the proprietary nature of investment management strategies, at the end of the day it is the investor's capital that is being allocated on behalf of the investor. The investment strategy must be transparent, easy to understand and repeatable. Most investors should not invest in highly levered, esoteric strategies unless they consider the invested assets to be truly disposable assets.

Seek Value On The Long And Short Side:

A core portfolio needs to offer the potential for consistent returns and must have the flexibility to be both long and short during volatile periods, giving managers the flexibility to protect the portfolio, while still capturing the upside.

Protecting the portfolio is key; without portfolio protection over the long term no amount of outperformance over the short term will really matter. Unfortunately, many investors have been learning that lesson the hard way. Moving forward, it's abundantly clear that the unnoticed conflict between the money manager and the investor can no longer exist. And by the way, we may all wish to ask our managers if they are getting a good night's sleep. This will be a sure sign of their alignment of interests.