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Sterling Investment Advisors Ltd.
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What criteria are appropriate to use in grading an investment/mutual fund manager?

By Timothy E. Flatley

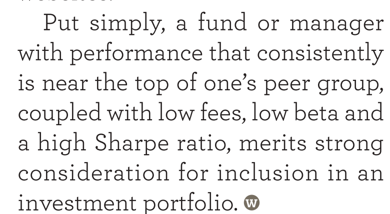
"Trust but verify." – Ronald Reagan

With thousands of investment managers and mutual funds competing for investors' assets, thoroughly evaluating the options can be a daunting task. While most individuals do not have the requisite time and resources to screen every aspect of a manager's profile, the following guidelines can provide the framework for a sufficient analysis.

Assessing the individuals behind the investment decisions is a logical place to start. The managers should have a minimum three-year history. Even though most frontline managers have been in the business for several years prior to actually taking the reins, leadership experience is critical. Steady leadership, coupled with a stable investment team, helps ensure the fund's focus remains consistent and true to its stated objective. This, in turn, enables a more accurate comparison to the fund's peers.

When measuring a fund or manager relative to its peers, total return is the principal criterion. The returns should be analyzed over one-, three- and five-year trailing periods. Shorter timeframes often overweight the effects of a few isolated investment decisions, while longer ones can include periods when the managers and objectives were substantially different than what is currently in place. The overall performance should be above the peer group's median during every period, which demonstrates a successful methodology. A fund's expense ratio or a manager's fee presents an automatic handicap for the investments to overcome. Some managers will point to their past performance to justify their relatively high fees. They may make a convincing argument, but there is no guarantee of future success and a below-average year will be magnified by exorbitant expenses.

Another important concern is the risk assumed to achieve the results. A fund's Sharpe ratio is one of the most popular measures of risk-adjusted return. The higher the number, the more the investment is compensating the investor for assuming a specific level of risk. Many advisors adhere to the tenet that when choosing between otherwise similar investments, choose the option with the highest Sharpe ratio. An investment's beta also helps an individual to discern if a manager is producing adequate returns for the risk. A beta of 1 signifies the investment has an identical level of risk as its benchmark. A beta greater than 1 implies more risk and vice versa. Both numbers are generally available on financial websites.



Put simply, a fund or manager with performance that consistently is near the top of one's peer group, coupled with low fees, low beta and a high Sharpe ratio, merits strong consideration for inclusion in an investment portfolio.

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