The Independent Financial Group

A Registered Investment Advisor

Institutional Money Management

Manager Screening/Selection Process

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Founding Principal
THE INDEPENDENT FINANCIAL GROUP
A Registered Investment Advisor
Fee-Only Wealth Management Planning
and Advisory Services

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A Registered Investment Advisor
Fee-Only Wealth Management Planning and Advisory Services

Institutional Money Management

An investment process suitable for clients with assets to be managed above $1 million

Separately Managed Accounts
Manager Screening and Selection Process

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The Management Screening and Selection Process

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While many IFG clients choose passive investment strategies utilizing model portfolios created with a combination of no-load index and exchange-traded funds (ETFs), others prefer a combination approach. Many clients with taxation concerns and portfolios in excess of $1 million often desire the ability to scale costs and prefer more direct ownership of investment securities coupled with sophisticated portfolio management services provided by institutional money managers through separately managed accounts.

There are literally thousands of firms providing portfolio management services for wealthy and mass-affluent investors, as well as for foundations, trusts, and institutions. However, institutional money management firms often have high minimums – many can require as much as $5 million to open an account – and since they don't market their services to a mass market, few investors even know their names, let alone are able to effectively perform the sophisticated due-diligence and analysis required to narrow the universe down to a final candidate list within the various asset classes and market sectors. The mass-market investor, after all, is used to getting advice from the financial entertainment media and buying mutual funds retail.

Matching the right managers with the right clients involves a two-track due-diligence process at different levels:

- **Track #1 – The client level**: The advisor works with the client to gain a thorough understanding of where the client is today, where the client wants to be in the future, and how the client wants to make the journey. This includes the process of defining goals and prioritizing them, establishing time lines and return requirements, and establishing a broad portfolio strategy based on an Investment Policy Statement (IPS) created with the client, based on assumptions regarding inflation, taxes, and future needs. The client is heavily involved in the decision-making during the planning process.

- **Track #2 – Management due-diligence**: This about screening the universe of institutional money management firms in order to arrive at a final 'recommended' list of managers who've `made the cut'. The final recommended list might, for example, include three to five managers in each asset class and sector. For example, among domestic U.S. stock managers, there might be three to five possible candidates for growth managers and value managers in the large company sector, as well as several candidates for government or corporate bonds, etc.

There's an old saying: Do what you do best. Hire people to do the things they can do better. While it's the advisor's job to know the client's situation and needs intimately (Track #1), the truth is there are firms far better positioned to conduct the initial screening process among the universe of managers (Track #2).

Many major firms use either their own in-house managers or management firms with whom they have 'selling agreements'. IFG's management level due diligence is conducted by independent third party providers with established credentials and industry reputations, and who are independent of the institutional managers they cover.

A Five Step Process

As an example, one of the due-diligence providers utilized by IFG follows a manager-level due-diligence process shown below to identify, assess, and monitor the money managers that make the 'approved' list.

Step One—Preliminary Screen

There are preliminary criteria Lockwood believes should be evaluated before a manager can be considered. Criteria may vary depending on the asset class of the money manager, and may include:

- **Assets Under Management (AUM)**—review of firm's assets managed in the strategy.
- **Manager tenure and verifiability of track record**—investment tenure of management team and length and quality of track record.
- **Consistency of personnel**—review of turnover among investment professionals.
- **Registration**—investigation of firm's investment advisory registration.
- **Disciplinary history**—review of litigation or involvement in any criminal or civil investigation.

Step Two—Quantitative Criteria

The next level consists of an evaluation of the manager's style behavior, consistency, potential added value and performance in different market cycles.

Again, some of these criteria may change depending on the asset class under consideration.

- **Consistency of performance relative to benchmark**—R-squared and tracking error are calculated and analyzed over various time periods against a benchmark selected by Lockwood.
- **Style analysis**—Typically, there are three different approaches: return-based analysis, fundamental portfolio analysis, and investment philosophy and process analysis. Typically, various databases are utilized to analyze style by a return-based regression methodology. This analysis may also help illustrate the amount of style drift over time.
- **Risk-adjusted measures**—This process analyzes performance generated per unit of risk taken by looking at the following factors over various time periods: up/down market performance, Alpha, Sharpe Ratio and Information Ratio. These numbers are analyzed relative to the benchmark as well as other similar money managers.

- **Performance consistency**—among other indicators, the screening process may use the ratio of the quarters in which the money manager outperforms to the quarters in which it underperforms and the money manager's performance in rolling time periods.

- **Market cycle analysis**—the performance of the money manager may be examined over various market cycles, such as up and down markets, and when the money manager's style is in favor versus when it is out of favor.

- **Total portfolio analysis**—Next comes the analysis of each money manager's potential contribution to overall portfolio return and risk when compared alongside complementary/non-correlated asset classes as part of a total portfolio strategy.

Step Three—Qualitative Analysis

This analysis helps determine if the factors that contributed to past performance may still be in place and positioned to contribute to performance in the future. The factors that are evaluated may include:

- **Investment team turnover**—tenure, experience, depth, continuity, and skill level of key investment personnel

- **Investment philosophy and process**—the portfolio construction process and underlying philosophy

- **Investment research process**—looks at where earnings estimates are generated, where they get credit research on bonds, where they have industry specialists, etc.

- **Implementation of the investment process**—the checks and balances in place at the money manager are examined, in an effort to help ensure that the investment process is implemented uniformly and consistently across all accounts.

- **Firm capacity and structure**—the firm's ability to accommodate future growth is evaluated. Lockwood also attempts to determine whether the firm has formal compliance and trading procedures in place.

Step Four—Investment Committee Review

The analyst conducting the analysis on the investment firm compiles a summary report, with a recommendation, and presents it to our independently chosen provider's Investment Committee . The committee discusses, probes, and may challenge the report before arriving at a final consensus opinion on the manager, which may include addition to the Research Coverage list. This forum is similarly used for money manager firms/upgrades/downgrades.

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Step Five—Ongoing Monitoring Process

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A main responsibility of the Research team is to stay abreast of changes taking place at money management firms on the research coverage list. The team seeks to accomplish this task through the administration of an ongoing monitoring process across.

This process is intended to ensure that money managers practice consistent application of their stated investment discipline. The team may also evaluate underlying factors pertaining to performance, specifically dispersion of returns among accounts and composite performance versus individual accounts.

There are multiple reasons why a money manager may be removed from the research coverage list. However, more often than not, there is one overriding factor that leads to this action. For example, deterioration of qualitative factors, such as personnel and organizational changes, would be a common cause for removal.

Change in Research Coverage

A change in status or removal from the research coverage list generally triggers a series of actions:

1. Depending on the platform, the decision is communicated to advisors and institutions with a memo detailing the rationale behind the decision.

2. There are times when alternative money managers might be identified that manage in the same investment style, so investors can decide with IFG's help if, when, and/or how to reallocate their assets.

3. Depending on the circumstances, the institutional due-diligence firm may help facilitate the transfer of assets to the replacement money manager. Note: Certain alternative money managers may accept accounts "in-kind," so subsequent liquidations can be structured to help avoid unnecessary tax consequences to the investor.

Conclusion

The processes I utilize are designed to live up to the name of the business. The Independent Financial Group is all about doing everything possible in an attempt to provide clients with <u>their own team</u> of world-class independent service providers in a way that avoids conflicts of interest, putting every team member on the `client's side'.

- ✓ Client planning and private advisory services without product sales: Jim Lorenzen, CFP®, Now in 20th year, with clients in New York, Florida, and California.

- ✓ Independent management research, due-diligence and reporting: Lockwood Advisors, Inc. The integrity and consistency of their research process helps advisors like yours truly to offer money managers under research coverage to clients with confidence. I have been utilizing their

independent research services for more than sixteen years; and the fact that so many of my clients have valued their services for so long would seem to validate their contribution.

- ✓ Independent asset custodian: Pershing, division of Bank of New York-Mellon. Founded by Alexander Hamilton in 1784, it's the oldest bank in the U.S. It made it's first loan to the U.S. Government during George Washington's administration ($200,000 in 1789) and was the first stock traded on the New York Stock Exchange. BNY is primarily a provider of global and domestic custody services, not a retail bank, and now has a presence in 33 countries with more than $24.5 trillion under custody and administration (as of 9/30/2010).

As stated earlier, third-party due-diligence and reporting is independent of the managers covered. Likewise, IFG is independent of both those service providers and the managers. IFG receives no compensation or incentives of any description from either of these groups. Clients receive a fully-disclosed breakdown of all fees outlining all compensation.

It should be noted that many investors today are unaware of the fees they pay and what `pay-to-play' arrangements exist behind the scenes. Quite often it just might be because the investment vehicle is sold by a sales person rather than screened and selected by an independent professional. That's just one level of professional service a client should expect from a `Personal CFO' who is truly independent of the due-diligence, reporting, custodial, and investment entities employed on the client's behalf.

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Financial and Retirement Planning ▪ Wealth Management

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