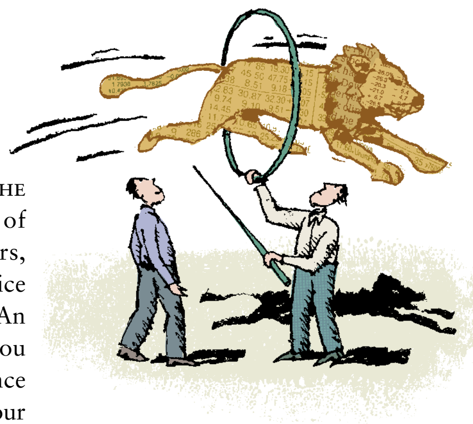
Show Time

Your quarterly performance reports can be a great arena for letting clients see how valuable you are to them

Scott Welch and Jamie McIntyre



TO SEPARATE YOURSELF FROM THE increasingly crowded field of professional financial advisers, you must provide exceptional service that investors can't find elsewhere. An ideal starting point—and a service you may be overlooking—is performance measurement and reporting. How your quarterly performance reports look, what they convey, and the degree to which they help you demonstrate the value of your services can make a difference in landing—and keeping—high-net-worth clients.

Many wealth managers fail to recognize that the quarterly performance reports they send clients are among the few physical manifestations of what they're doing. The reports represent a perfect opportunity to show clients in a very tangible way that you're adding value. As such, the report should do the following:

■ **Act as a reminder of the agreed-upon investment plan** Most quarterly reports present data rather than information. The client receives numbers on a page, frequently with no context. The report should compare the path the client's financial life is taking with the path planned out up front in a detailed investment policy and wealth-management plan. This plan should cover such issues as cash flow requirements, risk tolerance, growth and terminal value goals, time horizon, tax issues, and so forth. The quarterly performance report should enable you and your client to track the success of the plan and identify any problem spots.

■ **Present an objective performance assessment** First, the report should demonstrate how the overall plan is performing. Second, it should show how each investment is performing. Most performance reports contain information only on those managers or accounts for which the adviser is directly responsible. Yet, many high-net-worth clients have more than one adviser or manager and, typically, multiple custodian or brokerage accounts. Generating a report limited to one segment of the client's portfolio restricts the usefulness of the analysis. What if a client is properly allocated to large-cap stocks in the portfolio you oversee but extremely over-allocated to large-cap stocks elsewhere? What does this do to the overall risk and return characteristics? From a practice-management perspective, how have you differentiated yourself? Are you simply in a beauty contest with the other investment managers, including the client herself? By reporting on the entire invested asset base, you can become the financial quarterback, essentially eliminating the risk of being "backdoored" by another adviser claiming better performance.

■ **Explain the factors driving portfolio performance** Beginning with macroeconomic trends and shifts, the report should drill down from the performance of the overall portfolio to the performance of each asset class, to each manager within each asset class, and to the benchmark-specific performance for each manager. Only by reporting in this level of detail can you help the client identify outperformers or underperformers then make any necessary changes. Such a level

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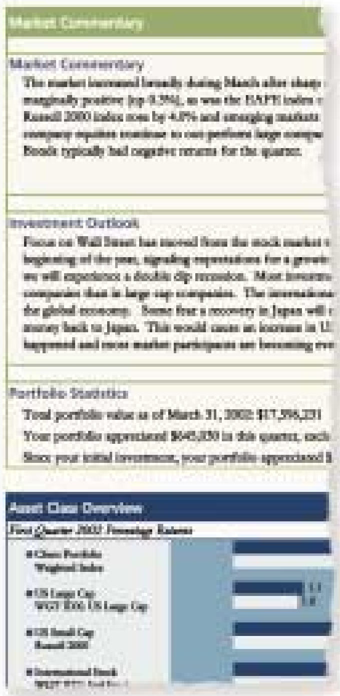
Illustration by Daniel Baxter

EXHIBIT 1: EXECUTIVE SUMMARY



of detail also enables you to add value, where appropriate, through tax management.

We segment them in a descending order from overall portfolio performance down to security-specific performance. This allows clients to focus on the level of detail they deem important. Many clients simply want to know what they're worth. For them, a comparison of the portfolio's value at the beginning and the end of the period may be enough. Other investors desire more. By presenting information in successively greater detail, the report becomes a flexible tool adaptable to each client's objectives, knowledge base, level of sophistication, and attention to detail.

The first element in our overall performance report is an executive summary. (See "Exhibit 1: Executive Summary," above. Click HERE to see a full view of Exhibit 1.) This single page provides a snapshot of how much money the client has invested and how the overall portfolio is performing. It also summarizes information about the macro trends in the marketplace that contributed to the performance: market commentary offers our investment strategists' views on the previous quarter, and an investment outlook presents a view on upcoming quarters. This page should also contain the current total value of all investment assets; the dollar-value appreciation/depreciation of the portfolio during the quarter, incorporating all investment activity but excluding capital flows; and the dollar-value appreciation/depreciation of the portfolio since the initial investment.

Finally, the executive summary should provide an asset-class overview and weighted index calculation. This allows the client to see at a glance how each asset class in his portfolio is performing versus the appropriate benchmark, and how the overall portfolio, weighted by asset-class allocation, is performing versus a weighted portfolio index. In other words, clients can see how much value, or alpha, many active managers are adding.

The executive summary should be followed by a portfolio review page summarizing the performance over time of the total invested capital. (See "Exhibit 2: Portfolio Review," below. Click HERE to see a full view.) Many investors—partly as the result of the tidal wave of information now available—tend to focus on short-term performance, so you must have tools available to bring long-term focus to the discussion. Our research indicates that the top quartile of active managers typically don't beat their respective benchmarks more than 50 percent to 60 percent of the months invested. Therefore, client focus on the short term can result in frequent turnover, as the investor continually tries to chase the "hot" manager or fund. Not only could this strategy hinder performance, but it will also increase taxes and transaction costs.

The portfolio review should give details that support the portfolio statistics in the executive summary: where did the client start, where did he end up, and why? For example, we prepare a summary table that shows, for each time period analyzed, the beginning market value, net capital inflows/outflows, investment gains/losses, fees and expenses, and the ending market value. Underneath the ending market value, we report the dollar-weighted return on investment, that is, inclusive of capital inflows and outflows.

The report should also show portfolio returns on a time-weighted basis—or, after negating the effects of any capital contributions and withdrawals. This is the industry standard for measuring a manager's success: managers shouldn't be unjustly rewarded for client contributions into rising mar-

EXHIBIT 2: PORTFOLIO REVIEW

EXHIBIT 3: ASSET-ALLOCATION REVIEW

kets or punished for contributions into a falling market. We show this time-weighted return both gross and net of management fees and expenses. In short, clients care about dollar-weighted, or spendable, return, and the advisers care about time-weighted, or manager-contributed, return. Both are critical to making decisions.

We use the portfolio review page to again highlight the value being added by active managers (and, by extension, the adviser who selected those managers) by comparing the portfolio return with a weighted-benchmark return. Such a comparison comes with a caveat: published index returns slightly overstate the results investors could achieve with passively managed index funds because they exclude fees. Therefore the weighted-benchmark return shouldn't include fees associated with buying index funds or other index-tracking investments, such as exchange-traded funds, as these fees vary from client to client.

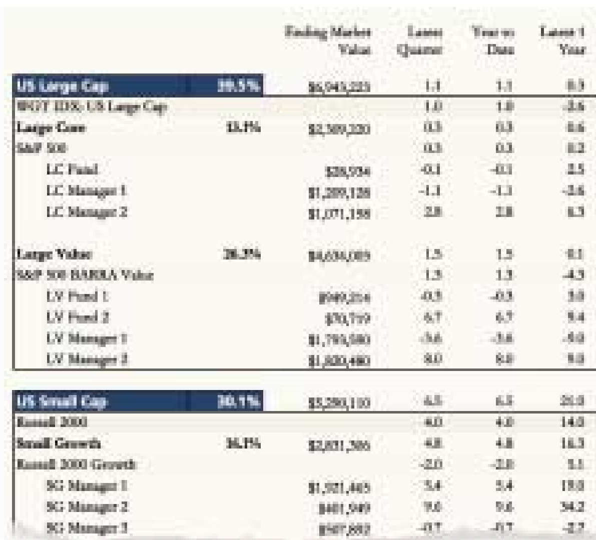
At the bottom of our portfolio review page we include a useful illustration depicting the market value of the portfolio overlaid against the actual capital invested over time. This graphic shows, on a monthly basis since inception, the initial contribution and cumulative subsequent contributions and withdrawals. Overlaid against this is, for the corresponding time periods, the net market value of the portfolio. This provides a clear and concise visual illustration of how the portfolio has performed.

In support of the portfolio review, the next page should be a specific asset-allocation review comparing the actual current allocation with the targets set forth in the investment policy statement. (See "Exhibit 3: Asset-Allocation Review," left. Click HERE to see a full view.) This provides the data necessary for timely and appropriate rebalancing and helps educate the client. For many investors, the notion of selling the winners and reallocating back into the losers is counterintuitive. But this asset-allocation review can serve as a reminder that the plan—not the performance of any given asset class or manager—will provide clients their best chance to meet their long-term goals.

An additional illustration that we include on the asset-allocation review page is a unit value comparison chart, which shows the compounded rate of return of the client's portfolio overlaid against the return of an appropriately weighted index. This chart provides a concise picture of two important aspects of portfolio performance—how closely the portfolio has tracked its weighted benchmark (in terms of both performance and volatility), as well as whether or not active management has added value. One word of warning: a unit value comparison chart may indicate more extreme outperformance or underperformance in the early years of investment before enough time has elapsed to smooth out volatility. Advisers and clients should take this into consideration when reviewing the performance of a young portfolio, one less than three years old, for example.

Once the overall portfolio performance has been reviewed, we then illustrate the factors that contributed to that performance. One useful way of presenting this information is in the form of a trailing returns summary. (See "Exhibit 4: Trailing Returns Summary," below. Click HERE to see a full view.) This summary shows the time-weighted performance of every manager, fund, or investment segment within the portfolio for various time periods. These per-

EXHIBIT 4: TRAILING RETURNS SUMMARY



		Ending Market Value	Latest Quarter	Year to Date	Latest 1 Year
US Large Cap	39.5%	$6,943,223	1.1	1.1	0.3
WGT IDX: US Large Cap			1.0	1.0	-2.6
Large Core	13.1%	$2,309,220	0.3	0.3	0.6
S&P 500			0.3	0.3	0.2
LC Fund		$28,934	-0.1	-0.1	2.5
LC Manager 1		$1,209,128	-1.3	-1.3	-2.6
LC Manager 2		$1,071,158	2.8	2.8	6.3
Large Value	26.3%	$4,634,003	1.5	1.5	0.1
S&P 500 BARRA Value			1.3	1.3	-4.3
LV Fund 1		$949,214	-0.3	-0.3	3.0
LV Fund 2		$70,719	6.7	6.7	9.4
LV Manager 1		$1,793,580	-3.6	-3.6	-0.0
LV Manager 2		$1,820,480	8.0	8.0	9.0
US Small Cap	30.1%	$5,290,110	6.5	6.5	20.0
Russell 2000			4.0	4.0	14.0
Small Growth	16.1%	$2,831,306	4.8	4.8	16.3
Russell 2000 Growth			-2.0	-2.0	5.1
SG Manager 1		$1,921,465	5.4	5.4	19.0
SG Manager 2		$401,949	9.6	9.6	34.2
SG Manager 3		$507,892	-0.7	-0.7	-2.2

EXHIBIT 5: ACCOUNT ACTIVITY SUMMARY

	Beginning MV	Net Flows	Net Transfers	Interest/ Dividends	Fees/ Expenses	Investment Gain/Loss	Ending MV
US Large Cap	$7,348,505	-	(465,736)	23,029	(19,220)	56,645	$6,943,223
Large Core	$2,762,327	-	(449,833)	7,767	(7,072)	(3,970)	$2,309,220
LC Fund	$28,970	-	-	-	-	(36)	$28,934
LC Manager 1	$1,686,839	-	(447,640)	5,444	(2,749)	(32,765)	$1,209,128
LC Manager 2	$1,046,518	-	(2,192)	2,323	(4,322)	28,831	$1,071,158
Misc. Large Cap Equity	-	-	-	-	-	-	-
Large Value	$4,586,178	-	(15,903)	15,262	(12,148)	60,615	$4,634,003
LV Fund 1	$953,649	-	-	-	-	(4,435)	$949,214
LV Fund 2	$66,305	-	-	85	-	4,329	$70,719

formance figures are then rolled up into their respective asset style then rolled up again into their respective asset classes, which are compared with the appropriate asset-class index. This allows the client to see how the various managers work together to contribute to overall asset-class performance.

Though managers and assets are identified in this summary, they are being reviewed only relative to their contribution to the overall performance of their class and style. Reporting the information over multiple time periods serves two purposes—identifying which asset classes are over- or underperforming, and more importantly, acting as a visual reminder that today's hot asset class probably wasn't hot three or five years ago. If presented properly to the client, this reinforces the argument for disciplined rebalancing.

The next level of specificity is an account activity summary. (See "Exhibit 5: Account Activity Summary," above. Click HERE to see a full view.) Each manager is again presented within the appropriate asset style and class, but now the analysis focuses on the drivers behind the most current quarter's performance. In tabular form, the path from the market value at the beginning of the quarter to the market value at the end of the quarter is drawn: beginning market value; plus or minus net capital inflows and outflows; plus or minus net transfers, or rebalancing; plus interest and dividends paid; minus fees and expenses; plus or minus investment gains and losses; ending market value.

The ending market value for each manager should match the value shown in the trailing returns summary, but this dissection allows you to help the client identify the specific contributing factors to that value. As a final "drill down," we summarize all capital inflows and outflows. (See "Exhibit 6: Portfolio History," right. Click HERE to see a full view.)

Once the overall asset classes and styles have been reviewed, the next level of analysis is to examine how each asset style—growth, value, or core—has performed, and how each manager within each style has performed. (See "Exhibit 7: Asset Style Review." Click HERE to see a full view.) Two relevant comparisons can be made here: how each manager performed relative to the appropriate benchmark and how each manager performed relative to peers within the same asset style. This level of analysis can reveal the degree to which overall portfolio performance has been affected by the performance of an individual manager or group of managers. Individual manager performance is frequently the primary point of focus for clients. By placing it this deep into the report, you send the message that short-term individual manager performance is relatively unimportant.

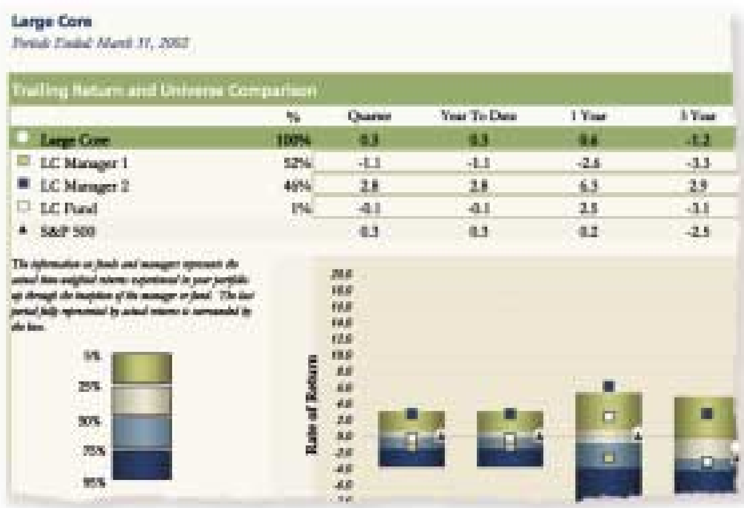
The top half of the asset style review shows a trailing return and universe comparison. The table includes time-weighted rates of return for the trailing quarter, year-to-date, and one-, three-, and five-year periods. The top row summarizes the market performance of the respective asset style—large-cap core, for example—with the subsequent rows summarizing the performance of each manager within

EXHIBIT 6: PORTFOLIO HISTORY

Sample Client Total Portfolio
Periods Ended: March 31, 2002

Contributions & Withdrawals		
From 1/01/02 to 3/31/02		
3/12/2002	(44,444)	Funds Transferred to Virtual Bank
1/16/2002	(15,556)	Transferred to FTCI Checking to cove
1/16/2002	1,302	Learning Tree Intl Check - DTD 11/1
1/4/2002	(266,667)	Funds Transferred to Virtual Bank
1/2/2002	(35,687)	Transferred to FTCI Checking to cove
TOTAL from 1/01/02 through 3/31/02: (361,051)		
Net Transfers To/From this Composite = (207,388)		

EXHIBIT 7: ASSET STYLE REVIEW



the style in decreasing order of their percentage of assets. The bar charts below this table illustrate how each manager's performance stacks up against the relevant index and relevant universe of managers for a specific time period. The height of each bar shows the volatility of returns of the various managers for that time period. Ideally, each manager should place within the top quartile of performance within the universe of managers using that asset style. But again, discipline is the key. Certain managers may be underperforming the market index, but those same managers may show strong outperformance over a longer time horizon.

At the bottom of our asset style review (not shown above), we include a scatter chart illustrating a trailing risk-and-return comparison of each manager relative to the relevant index. The intersection of the crosshairs represents the realized risk and return for the index, and each plot point represents the risk and return characteristics for a given manager. The ideal position is the top left quadrant, which represents higher return and lower risk than the index.

Following the asset style review, it's now appropriate to focus on the details of individual manager performance. For each manager, we prepare a one-page summary that shows the manager's performance on an absolute basis, since inception, broken down by investment gains and losses, interest and dividends, fees, and contributions and withdrawals. (See "Exhibit 8: Manager Detail," right. Click HERE to see a full view.)

The manager review page should also compare the manager's performance with that of a relevant benchmark. This can be depicted in several ways: First, you can make the comparison over multiple time periods, which again serves as a reminder to the investor that the focus should be on the long term. Second, you could use a unit value comparison chart tracking the cumulative performance of a single-unit investment with the manager versus a single-unit investment in the underlying index over the same period.

The comparison chart must be used with caution: clients can easily "lose sight of the forest for the trees"—in other words, focus on a specific manager's individual performance rather than overall portfolio performance. They need to be reminded often that asset classes and styles go in and out of favor.

Finally, if your client requests it, you could drill down one additional level and look at the performance of each individual security. But this level of analysis is probably more useful for the adviser, who can use the information to help manage taxes.

The upshot: As a financial adviser, you can't control investment returns on a macro basis—nor can you control the markets. For this reason, a business model that focuses solely on investment performance is fundamentally flawed: investors who are drawn in by current returns are at risk to depart once those returns fall off.

A more successful, long-term business model is to focus on factors you can control, such as taxes, fees, and service; educate and constantly remind clients that it is the investment plan—the setting of goals, the construction of a portfolio, and the disciplined implementation, review, and refining of those goals—that ensures long-term success. Properly constructed and used, the performance report not only supports this business model, but also acts as the physical representation of both the plan and the value being added by the adviser. WM

EXHIBIT 8: MANAGER DETAIL