4 Ways to Determine If a Fund Manager Has Your Best Interests at Heart

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A wealth of information available from third parties, in consultant databases and on manager websites can help investors understand a manager's performance pattern, philosophy, process and other key details. But also critical for long-term success is working with managers who truly align their interests with investors. To understand whether a manager has investor's best interests at heart, clients should ask the following questions.

1. Is portfolio management compensation structured to incentivize long-term results?

Portfolio manager compensation is perhaps one of the hardest areas to attain perfect transparency on. You typically won't find information on how a firm pays its portfolio managers on its website—even publicly traded firms may only be required to include certain financial information in their annual report. So what can investors do? When performing due diligence, investors should ask managers directly about their compensation structure to determine if portfolio managers are incentivized to generate alpha, gather assets, or both.

Investment managers may be incentivized to grow AUM as opposed to delivering long-term alpha. Under that common compensation scenario, time spent attracting new clients can act as a distraction from delivering outstanding investment results for existing clients. In addition, AUM may grow to the point where it begins to impede the manager's ability to generate excess returns.

While using multiple time periods (i.e., one-, three-, and five-year, etc.) is common industry practice, Diamond Hill ties investment team compensation to long-term investment results (specifically, rolling five-year periods). If a portfolio manager has less than a five-year history on a strategy, results are measured from the date the individual began managing the strategy and are used as a reference point in determining incentive compensation.

2. Does the portfolio manager(s) eat his/her own cooking?

Beyond the fiduciary responsibility to put clients' interests first, research has shown that managers who align their interests with those of their clients by investing in their own strategies achieve better results over time.[1]

At Diamond Hill, all portfolio managers have a significant personal investment in the strategies they manage. By investing heavily alongside our clients, we ensure that portfolio managers treat their strategies as though it were their own money—because it is. In addition, all Diamond Hill associates are granted shares of Diamond Hill stock on their first day as an employee that cliff vest after five years. We believe making all associates actual owners of the firm helps foster a long-term, ownership mindset that also aligns their interests with our clients.

3. Are management fees in line with, above or below industry averages?

Nothing eats away at capital gains like excessive management fees. Fees have come under intense scrutiny in the asset management industry over the past decade as low-cost index products gained in popularity. While there is no such thing as a free lunch, fees should reasonably reflect the strategy and associated risks.

At Diamond Hill, we believe clients are best served by a fee that is low enough to allow us to achieve meaningful outperformance relative to a passive alternative; yet at the same time, a fee that is high enough to allow us to build and maintain an investment team capable of achieving such results. To achieve a fair sharing of economics with our clients, we aim to structure our fees to be competitive within our industry.

To demonstrate our commitment to client alignment along with our long-term discipline, we also offer a variable fee structure to clients that puts us firmly on the same side of the table.

4. Does your investment manager responsibly manage capacity of its strategies?

In the asset management industry, there is an inherent conflict of interest between asset managers and clients: Greater assets under management (AUM) leads to higher revenue for the manager but can potentially negatively impact performance for existing clients. As such, capacity discipline is a critical component of an active manager's ability to add value for clients.

[1] Morningstar, *Why You Should Invest With Managers Who Eat Their Own Cooking* (March 2015).

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At Diamond Hill, our focus is on long-term performance rather than asset growth, which incentivizes our portfolio managers to prioritize existing clients and close strategies before they reach a size that could limit their ability to deliver value-added returns. We also believe in giving portfolio managers discretion in determining capacity for the strategies they manage, including decision-making rights on closing to new investors.

While there is no perfect formula that determines the exact capacity for a strategy, we believe the most impactful factors[2] include:

- A manager's ability to take a meaningful position in securities across the full opportunity set.
- Liquidity of each security and the portfolio as a whole.
- Retaining long-term partnership with existing clients.

Investors should always ask managers how they approach capacity management—even in those asset classes where higher AUM levels are typical. For example, the large cap asset class is usually one where managers have more room to grow AUM before impacting their ability to add value. But even modest asset levels can begin to impede a large cap manager's trading capabilities or their ability to establish meaningful enough positions in a portfolio to make a difference.

Conclusion

While most asset managers will claim to be client centric, the facts can sometimes reflect a different reality. It is critical for investors to assess managers not solely on historical returns but also on the manager's ability to clearly demonstrate its commitment to align its interests with those of its clients.

DIAMOND HILL ALIGNMENT OF INTERESTS

[2] Download our paper, The Art & Science of Capacity Discipline, for a more in-depth discussion about Diamond Hill's approach to capacity management.

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