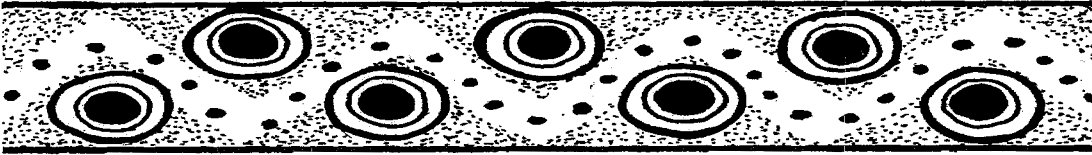
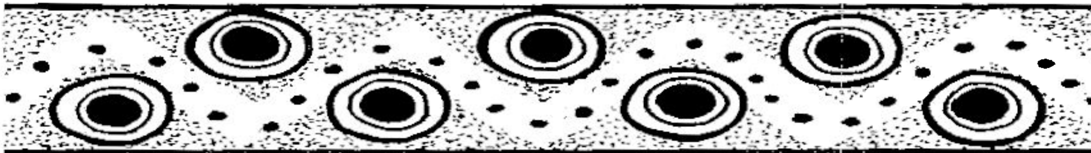


EVALUATING AND MONITORING INVESTMENT ADVISERS

What You Need to Know To Keep Your Investments on Track

by Gelvin Stevenson



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italicized items are illustrations

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Box 217, Cass Lake, MN 56633-0217. Phone 218-335-8583. Fax 218-335-6562.

Write by Gelvin Stevenson (Cherokee).

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Introduction

This volume is one of a series of handbooks for Native American tribes that want to take control over their own financial resources and to manage them well. We introduce the series first, and then this book, *Evaluating and Monitoring Investment Advisers.*

... To This Series

Something new has happened in Indian country. For the first time, a substantial number of Nations now have, or will soon have, money to invest. For many tribes, that money had been held in trust and managed by the Bureau of Indian Affairs, Division of Trust Management. Only now, after much hard work, are tribes winning the right to manage that money. In addition to the BIA Trust money, many tribes have received land claims settlements, or are earning money from tribal resources or gamin or other tribal enterprises. While the sources of this new money may vary, it needs to be managed, and managed well.

Since having money to invest is a new experience for most tribes and Native people, we often lack the experience and skills necessary to invest and manage it properly. Even people with formal education may know little about investing, and those tribal members who do understand investing may not be familiar with the world of institutional investing, which is populated by specialized laws, companies, concepts, practices and people. To manage a tribe's investment portfolio well requires knowledge not only of your tribe's needs, but also of the money management industry and its concepts and language.

This series was written to introduce tribes and tribal members to the world of institutional investing and money management. It includes three short books: ***Investment Principles***, ***The Investment Industry***, and ***Evaluating and Monitoring Investment Advisers***.

This series is intended for tribal treasurers, controllers, investment officers, chairmen, chiefs, council members, members of finance committees, trust committees, judgment fund committees, and all other interested tribal members.

This information is meant to teach and guide, to start you off in the right direction. It is not an encyclopedia. Nor is it a bible. It is a beginning.

Your money is important enough that, in most cases, you should hire professional help. We will discuss below what kind of help you might need and where to find that help.

This handbook was funded by the Northwest Area Foundation, as part of its ongoing efforts to build the capacity of tribes and other institutions in the northwestern U.S. The Foundation seeks "to contribute to the vitality of the region by promoting economic revitalization and improving the standards of living of the most vulnerable of its citizens." The Minnesota Chippewa Tribe received and administered the grant, through its Economic Development Division. The author thanks Karl Stauber and Terry Saario of the Northwest Area Foundation for their encouragement and support and Gary Frazer and Richard Robinson of the Minnesota Chippewa Tribe for their cooperation and assistance.

Thanks, too, for their careful reading and helpful comments on early drafts, to Mike Roberts and Bruce McKay, First Nations Development Institute; Lynn Giago, Piper Jaffray and First Nations Oweesta Advisory Committee; and Debra Powless and Raeann Skenendore, Oneida Trust and Enrollment Committee.

Any errors are my responsibility, and I would appreciate having them pointed out to me at 2160 Bolton St., Apt. 3B, Bronx, NY 10462, 718-863-4156.

The Foundation wants to make clear that their support of this series should not be read as an endorsement of the author in any way other than as the author of this work. In other words, the Foundation does not want to imply that it favors this author over any other professionals working in this area.

This handbook is the work of a particular person who has his own way of understanding and communicating. Like all information, it should be carefully evaluated by the reader. Part of that evaluation requires knowing something about the author.

My name is **Gelvin Stevenson**. I am Western Cherokee. I work as a Financial Consultant in New York City, have a Ph.D. degree in economics, have been a business and financial writer at *Business Week* and elsewhere, and worked as a stock broker for a brief interlude. A main interest of mine is Socially Responsible Investing. I currently serve as a Director of the First Nations Development Institute, the American Indian Community House in New York City, and the Environmental Research Foundation, and sit on the Council of the Nuygulí Keetoowah Society in New York City.

My political bias is toward the sovereignty of Native American Nations, and their well-being as they define it. I value the traditional ways, and feel that the best way to strengthen our traditions is with education and sophistication. In the area of money management, that means learning how other people and institutions manage money, and applying those insights and skills to managing our own money our own way for the goals that we define, thinking always of our children and all children to come.

... To This Volume

Any time you employ a professional, you monitor his or her performance. Normally, however, such monitoring is not rigorous or systematic. One tends to trust doctors and lawyers and accountants. And if they do something wrong, you know it. You do not need to hire someone else to evaluate them.

Investing is different. People who manage your money should be monitored carefully and often. Luckily, it is easier to monitor money managers than doctors and lawyers. Investing is highly quantitative and a great deal of comparative information is available. Also, there is a huge variety of money managers to choose from. You may want a doctor and a lawyer who live nearby, but physical proximity is relatively unimportant for a money manager. You can choose one across the country or even around the world.

This book presents the basics you need to know to monitor your investment advisers. We begin with an overview of the reasons to monitor, who should do it, at what level, and how often it should be done. Then we turn to comparisons of your investments with your investment policy. You should begin by comparing your investment policies with your

portfolios. Have you chosen investment advisers who fit your needs, and are they actually investing the way you instructed them? We then move from comparing investments to investment policies to evaluating their performance. How do you know how well your investments are doing? What should you be comparing them to? Which indexes? Which other managers? And we point out some danger signs. Following that, we discuss monitoring the monitors — consultants, as well as custodians. Over time, you may want to develop your own monitoring capability, and we talk about how to do that. We close with a discussion of resources that you might find useful.

One grammatical note: Throughout, I usually use the term "investment adviser" to refer to the person or company who is investing your money. The legal term is Registered Investment Adviser. On occasion, I substitute the formal name or use the term "money manager," which is commonly used by the industry.

1 Monitoring Your Investments — An Overview

Why Do It?

Tribal investment professionals and members of appropriate committees have legal responsibilities — as fiduciaries — to monitor the investments that they are responsible for. Even more important, however, is the moral and community responsibility you carry. The funds you are responsible for investing are very important to the future of your tribe. If managed well, they can lay the foundation for a solid future for many, many generations to come. If squandered, they become another sad story of foregone opportunities.

You must monitor not just to avoid corruption, although that is certainly one reason. Monitoring requires you to communicate with your Investment Adviser, and shows them that you are on top of the situation, and those facts alone could lead to improved performance.

You must also stay on top of your investments because situations and circumstances change, and investments may have to be changed as well. As in all life, the only constant is change. Just because investments are performing well now does not mean that they will continue to perform well. Having your car pointed straight on the road doesn't mean you can go to sleep at the wheel.

Who Should Do It — You or a Consultant?

There is a new profession, known as investment consultants, that has grown in step with the institutional investing industry. In addition to tasks like helping you make asset allocation decisions and to search for money managers or custodians, consultants help you monitor your investments. But do you need to hire a consultant? Can't you monitor your own investments?

True, you can do a lot of your own monitoring yourself. In fact, if your tribe is large enough, you might want to set as a goal the development of internal monitoring capability. But there is a great deal of specialized knowledge involved in evaluating portfolios and there is also a great deal of proprietary data that is necessary to perform some evaluations.

The need and the appropriate place for a consultant will become clearer as we discuss what is required to monitor your money managers. For now, I recommend using consultants, but with the idea of learning what they do, how they do it, what software and other products are available, and where they get their data, and using that knowledge to build the internal capability of doing a lot of your own monitoring.

How Often Should You Monitor Your Performance?

There are various levels of monitoring, and they should be done at different times. Some should be done quite often, but other levels of monitoring need be done only quarterly, and still others every few years.

The most basic level is to review the information that comes into your office to make sure it is correct. Brokerage firms can make mistakes. Computers and all. So review the confirmations that are sent to you when one of your investment advisers buys or sells a security. Make sure the investment is consistent with your Investment Policy Statement and with other instructions you have given your manager. For example, do you have a policy of avoiding companies A, B and C, for example, because they have polluted reservations? Make sure your investment advisers doesn't slip and purchase one of them. Also, check things like account numbers and amounts.

Every month, make sure the confirmations you received during that month match the information on the monthly statements. And check the confirmations carefully to see if any deposits or withdrawals you made are correctly recorded. Also make sure that there are no unauthorized withdrawals. You can think of this as somewhat like balancing your checkbook.

In general, make sure you understand everything that is on the statement. If there is anything — ANYTHING — you don't understand, get right on the phone to your investment adviser and have him or her explain it to you. It's your money and you have got to understand everything happening to it. In addition to these periodic reviews, you might want to check with your accountant to see is he or she has a particular monitoring or reconciliation methodology to suggest.

Every three months, a week or so after the end of each quarter, you should receive a quarterly report from each investment adviser. These vary considerably in what they include and how they appear, but at the very least they should all provide summary data about the performance of the portfolio over the quarter. The report should show total contributions, withdrawals, income and capital gains. It will probably also indicate securities purchased and sold during the quarter, and the quarterly fees. Many include discussions of current economic and financial market conditions and the firm's approach to the market.

You should review these quarterly reports carefully. First, every so often, add up the monthly reports to make sure they add up to the quarterly numbers. Then make sure the reports answer all the questions you have about your portfolio during that quarter. If there is anything not included that you would like to see included, ask your investment adviser for the information and to include it in subsequent reports. For example, would you like the quarterly return compared with various indexes, like the S&P500 or the Russell 2000? Is there some piece of information or perhaps a different style of presentation that one of your investment advisers uses that you would like the others to include? Then ask for it. Trust your instincts about what you would like to see. You'll get ideas from other managers' reports, as well. Eventually, you'll have all your managers reporting in truly informative ways.

Evaluate Your Portfolios against Your Investment Policy Statement

Before you started investing, your tribe should have written your Investment Policy Statement (IPS). The IPS states when and for what you will need the funds. That plus other information tells you how to invest, including how to judge and compare your investment

performance.) In that document, you should have established "benchmarks" and "universes" to use to judge the performance of your investment adviser, and you should have included those benchmarks in the written agreement with your investment adviser. If you did that, then you merely compare the investment adviser's performance with the benchmarks. (Benchmarks and universes are discussed below.)

You must be aware of the details of how your investment advisers calculate and present the performance measures. In the past, there have often been problems with the ways some investment advisers present and measure their results. This meant that an investor could not always be sure if even so basic a concept as annual rate of return meant the same thing from two different investment advisers. For example, did both assume dividends were reinvested? Did that return include their management fees? If that was an average return for all the portfolios the investment advisers manages, did some portfolios do better than others? How did they handle the problem of money being contributed or withdrawn during a month? Did they measure any non-liquid investments consistently?

To help solve these and other problems, the investment advisory industry, through its industry association, the Association for Investment Management and Research (AIMR) has recently issued standards and is encouraging all investment advisers to comply with the standards. They are presented in a booklet, ***Performance Presentation Standards 1993***. (See the section below on Resources.) (This is available from AIMR at addresses: PO Box 3668, Charlottesville, VA 22903.)

I strongly recommend that you get that book and specify in your contract that your Investment Adviser abide by those standards, or explain why it doesn't. Your Investment Adviser should verify his or her compliance, and so should his or her accountant, or some other third party. In the AIMR's approach, verification has two levels: Level One Verification attests to the fact that all of a firm's portfolios are included in its performance calculations. Level Two Verification includes Level One and also examines the actual data used in the calculations to ensure they are error free. The book contains more information about standards and verification.

With this overview in mind, we now discuss the oversight process in greater detail.

2 Step 1: Comparing Your Portfolios to Your Investment Policies

Introduction

The first step in monitoring your money managers is to make sure they are managing your portfolios according to your guidelines. To begin with, every quarter, you should compare your individual portfolios to your Investment Policy Statement (IPS) to make sure you are still following your policies. Also, be sure to compare your composite or aggregate portfolio (what you get when you add all your portfolios together) with your IPS. Even if all your individual portfolios are in line with your IPS, your composite might violate your IPS. For example, if your IPS includes limits on, for example, corporate bonds as a percent of total fixed-income securities, then you have to add up the corporate bonds in all your portfolios to know if you are adhering to that policy.

To simplify this task, you could set up a check-off sheet. This should list, in summary form, the policies from your IPS that you want to consider. It should list things like your asset allocation, risk targets, return targets (expressed as percentage returns, indexes and/or benchmarks), and any prohibitions you have instituted, like avoiding securities in corporations that fail environmental or other screens.

Individual and Composite Portfolios

In addition to comparing your investment policies to each portfolio, you should add up your portfolios to get a composite portfolio. (This is a job you might want to give to your consultant or your master custodian, if you have one.) You might want one fixed-income composite portfolio that summarizes all your fixed-income investments, an equity composite, and a total composite.

One thing you might find when you prepare a composite portfolio is that your actual investments do not match your asset allocation goal. If you began with an asset allocation of, for example, 50% equities and 50% fixed-income, and stocks do very well one quarter, your asset allocation could shift to 55% equities and only 45% fixed-income.

That is no cause for alarm, because it may go back the other way the next quarter. Also, you do not want to make sudden changes. But you do want to start watching it if it keeps moving in one direction, and make appropriate changes, say, every year, or when it exceeds your goal by a certain amount.

Another thing that a fixed-income composite portfolio might find is that you have too many investments with one maturity. Or your equity composite might show too many investments that do not pay a dividend. Also, if you have a policy on, say, dividend-paying stocks, and hire a new manager that is a growth equity manager, your percent of dividend-paying stocks in your composite might drop below your policy target (because growth stocks are less likely to pay dividends).

3 Step 2: Evaluating Investment Performance of Your Portfolios

A. Introduction

There are two kinds of performance: absolute and relative. Absolute targets, like 8% or 10% per year, every year, are very difficult to achieve in areas as volatile as the financial markets. For that reason, performance goals are usually presented in terms of relative returns, comparing your performance against how other investors have done that period, or how the overall market performed. Other investors and the market are measured against several benchmarks, such as the S&P500 and the Russell 2000. (See the section on indexes in the booklet on ***Investment Principles***.)

You need to evaluate the performance of your investment portfolios against several different measures, which we discuss in turn:

- other portfolios managed by the same manager,
- other portfolios of the same investment style managed by different managers, and
- indexes.

Your Portfolios vs. Other Portfolios Managed by The Same Adviser

To judge your portfolio against other portfolios managed by the same firm, ask for this data, and **make sure it has been audited at least annually by an independent auditing firm**:

- the number of portfolios they manage
- the average return of ALL those portfolios
- the median return of ALL those portfolios (the median has half the group above it and half below it, while the average may be pulled up or down by one portfolio that did exceptionally well or one that did exceptionally poorly)
- the range of return of ALL those portfolios

There are many good reasons why several portfolios managed by the same firm will have different returns. The money to be invested may have come in at different times, after the market had dropped, or risen. If Portfolio A had been invested when the average share price was $40, and Portfolio B was invested two months later, when average share prices had dropped to $38, then Portfolio B will have a greater return at the end of the year.

Also, money invested at different times may be put into different stocks. And the individuals doing the actual hands-on managing of the portfolios will not have identical records, even though firms are supposed to have controls in place that ensure that all portfolios are run roughly the same.

Your portfolio should perform at or close to the average of all of that individual's portfolios, and of all the portfolios managed by that company. If not, you should ask why, and not be satisfied until you understand exactly why that is the case.

Your Portfolios vs. Other Advisers

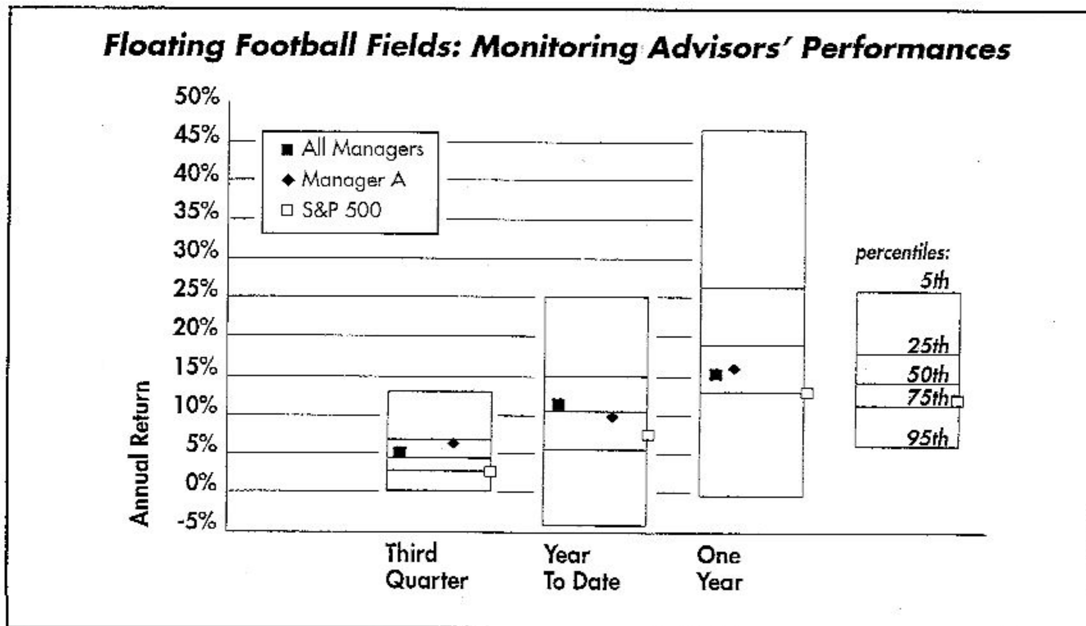
Once you've determined that your portfolios are being managed as well as the other portfolios by your investment adviser, you need to check how well other portfolios managed by other Advisers who use the same or similar investment styles. (You don't want to compare a value manager against a growth manager because that is not a fair comparison. Typically, one will do well in some types of markets, and the other in other types.) The groups of similar managers you compare with your manager are generally knows as "universes."

To make those comparisons, you need a lot of data on the investment performance of various investment advisers. Unfortunately, that data is not freely available to the public. For the most part, it is collected only by private parties, and sold to consultants and institutional investors. Some of the groups that collect the data do sell it, however. Many sell it to consultants, and some sell it directly to the public, usually on diskettes, ready to go into your computer. (A few of these data sellers are listed in the Resource section below.)

One problem with these universes is that they are not universal. In other words, they don't cover the entire universe of that kind of advisers. They cover only the advisers that the particular company or service collects data on. Clearly, the performance of your adviser will appear to be better or worse depending on the performance of the universes you are comparing it with.

The performance of other managers are generally laid out in graphics form. The assumption is that you want to know where your manager ranks compared with the distribution of managers, not just the average. So you are given data on the performance of the several different percentiles, usually the 5th, 25th, 50th, 75th and 95th percentiles. The number for the 5th percentile is the performance figure — annualized percent return — that was beaten by only 5% of all managers in that universe. That is very good performance. 25% of the managers exceeded the rate of return for the 25th percentile. Similarly for the other percentile figures.

The charts that generally represent such data are "floating bar charts," and are often called floating football fields. Part of a sample report is reproduced below.



This part of your evaluation can be very revealing. It will show you just how well your manager stacks up against the other managers that you could hire that work in the same investment style. It's not so bad if your manager underperformed for a quarter or two or three, but if your manager consistently underperformed over a two and three year period, than you had better think hard about why you are leaving your money under his or her control. And think, too, about how much it is costing you to do so.

Your Portfolios vs. Indexes

The other major comparison most institutional investors make is to various indexes. The idea here is that indexes, which reflect the performance of a large number of stocks, often are used as targets that you want your portfolios to equal or exceed. In addition, indexes may outperform or underperform most managers. Further, indexes are an investment option for institutional investors. (This is the active vs. passive management that is often discussed by institutional investors, consultants and academics.)

Indexes are single numbers that represent a basket of goods. In other words, indexes are one number representing a large number of component pieces. They are useful in allowing you to compare how well your portfolio of stocks is doing against other, very broad groups of stocks. For example, you may think you're doing well if your portfolio is up 10%, but if the indexes you have chosen as your benchmarks are up by 20%, something is wrong. Indexes give you a good representative mix of stocks to compare your performance to.

There are many indexes to compare your portfolios returns with, maybe as many as 600, although there is no central listing, partly because new ones are often being created, and some institutions create custom indexes for their clients. But there are less than a dozen that you need to become familiar with.

Selecting an index to compare your portfolio performance with should be an easy job, because you will already have thought it out when you wrote your Investment Policy Statement. That document should contain the indexes that you want to match or exceed.

It is useful and often interesting to include your chosen indexes in the floating bar charts that compare your performance against the universes. That will show you how your performance compared to the universe of similar managers and to the indexes at the same time. It will also show how the active managers did compared to the passive indexes.

Protecting Yourself from Misleading Data

On all-too-many occasions, investment advisers present misleading performance data to consultants and data services. There are stories of institutional investors reading in some publication that his or her investment adviser had achieved a high total return when the portfolio that the very same adviser ran for the institutional investor had returned substantially less.

In fact, there are many ways to present "performance," and you need to read the fine print to make sure you understand what performance you are reading about and how well your investment manager is doing for his other portfolios.

Danger signs include **unaudited** performance data, performance data based on **only part** of the funds a manager has under management, and performance data based on **"model"** or **"representative"** portfolios.

Here are some rules to follow to ensure that you are working with and relying on accurate and useful data:

1 Make sure performance data is audited, at least annually.
2 Do not trust data based on "model portfolios" or "representative portfolios."
3 Reject data based on less than 100% of the assets under management. .
4 Require your **consultants** to accept and present to you only audited, complete data from investment managers.

When you request performance data, specify that it should be audited at least annually and that it should state clearly what portfolios are included and what are omitted.

4 Evaluating Consultants

This is a more subjective evaluation. It is difficult to quantify the job of consultant. You should start by asking the basic question of whether you are satisfied with the job they are doing for you. (The issue of fees is covered in the booklet on ***The Investment Industry.***) A useful publication is "Controlling Consultants," which is available from First Nations Development Institute and referenced in Chapter 6: **Resources**.

Here are some questions you might want to ask yourself, about how they treat you and how they treat the committees and tribal members:

- Do they present everything clearly?
- Do they encourage you to ask questions?
- Do you feel comfortable asking questions?
- Do they empower you and make you more independent by providing you with information that reduces your dependency on them?

Anyone taking on a new enterprise must rely on people who are more experienced and knowledgeable. That makes you somewhat dependent on the experts you hire. But some of those experts will empower you, teaching you what you have to know, while others will keep you dependent on them. (Consulting is, after all, fairly competitive work, and it does pay well.) Gradually, your goal should be to do most of your own monitoring and evaluation yourself. You may keep consultants for continuing education, specialty work and for their access to proprietary data.

One step in the process of monitoring your consultant and developing your own monitoring capability is to develop your own evaluation presentation format. Begin with the format your consultant or broker or investment adviser uses. But make sure that presentation tells you what you want to know and does so in the way that is easiest for you and for your committee members to understand. A good place to start is with the suggestions listed in this book. That tells you the **content** that should be presented. Then you will have to decide on the **form** in which you want it presented. The only rule there is that the form should be the one that makes it most clear to you.

6 Resources

The following are books and services available to institutional investors. There are many more than listed here, and this should be seen not as exhaustive or even necessarily the best collection (since an evaluation of all that is available has not been carried out), but only as suggestive. For other references and resources, you should check the other handbooks in this series.

Books

Ellis, Charles D., ***Investment Policy: How to Win the Loser's Game,*** Second Edition, Business One Irwin, 1993. This is a sobering, high-level, well-reasoned book on investment policy. It is based on modern portfolio theory (although it is not mathematical), and argues that most money managers can not beat the overall market. It will sharpen your thinking, whether or not he is correct about beating the market.

Owen, James P., ***The Prudent Investor, The Definitive Guide to Professional* Investment Management**, Probus Publishing Company, Chicago, 1990. Two chapters in this book are particularly useful in monitoring your investment advisers. Chapter Seven, "Knowing When A Manager is in Trouble," discusses danger signs. Chapter Six, "Staying On Target," which dissects common mistakes many investors make when they monitor performance.

Performance Presentation Standards 1993. Association for Investment Management and Research (Available from AIMR at addresses: PO Box 3668, Charlottesville, VA 22903.) This book describes the standards developed by an industry-sponsored committee on the way computations should be made. It provides an excellent discussion of many issues, sometimes subtle, but always important.

Controlling Consultants, written by Dr. Ira Resnick, who has witnessed consultant abuses in developing countries as well as in Indian Country. Tells you how to be in charge of the consulting relationship. Available from:

First Nations Development Institute, The Stores Building, 11917 Main Street
Fredericksburg, VA 22408, 703-371-5615

Software and Data Services

There are several software and data services that sell to consultants or to institutional investors directly. Their products are not cheap (generally several thousand dollars), but might be useful as you develop your own internal capacity to evaluate your investments.

The MOBIUS Group puts out a Performance Reporting System and an Investment Manager Database System on disk that you can use on your own computer. They have over 1,100 firms and 3,400 investment products in their database. You can create your own reports, using 25 pre-defined universes or universes you create using any combination of their 400 criteria.

MOBIUS Group, P.O, Box 13959, Research Triangle Park, NC 27709,
800-MOBIUSG (or 800-662-4874)

INDATA will keep track of your securities and your portfolios, providing individual or composite holdings and analyses on a weekly basis. It compares them with market averages and similar funds within INDATA's universe of clients. Other services include monitoring selected securities and a comprehensive, computer based, portfolio management, performance measurement, and security analysis system.

INDATA, Gordon, Haskett & Co., 5 High Ridge Park, Stamford, CT 06905,
800-243-4060

Appendix: Summary Steps in Monitoring Your Portfolio Performance

1. Gather and analyze performance data, e.g. total returns net of fees on a quarterly basis, comparative data for similar investment funds, and volatility.

2. Compare performance with the goals of the Investment Policy Statement.

3. Compare performance of your portfolios with other portfolios managed by the same manager (and using the same investment style). Data sought will include:
   - average return for all portfolios under management
   - range of returns
   - median return

4. Compare performance with that of other managers using the same investment style (normally called "universes.")

5. Compare performance with various financial indexes, e.g. S&P 500, Russell, bonds indexes.

6. Compare your portfolio characteristics with those of the S&P 500. These characteristics include the price-earnings ratio, amount of debt, yield, growth rate, book value, return on equity, and others.

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