From CEO's Desk

Manoj Shenoy
Chief Executive - Wealth Management

Think twice before firing your Financial Advisor?

Investing is an extensive subject and there is something new to learn every day. The process of investing is a very long drawn process. The results of the good work put in this process may or may not bear expected results in the long term. However, the effort is always worth it - remember it's your own money we are talking about!

Not everyone has the time or the mental framework for managing their investment portfolio. The need for financial advisor is a topic which in itself is critical; however this article doesn't aim to bring that point out. We are aware of the fact that selecting a financial advisor can be an intimidating task. There has to be a perfect match of investment philosophies, working chemistry, view on long term goals and more. Theoretically speaking one needs to find a Charlie Munger for his/her Berkshire Hathaway, but that surely sounds easier said than done.

While finding a right financial advisor is a tough ask, the decision to fire the existing one keeps crossing your mind all the time. You are haunted by the thought that the advisor is not doing enough. Most people turn to relative performance comparison as a tool to evaluate the financial advisor and there is no denying that performance is not important. However, the approach is faulty as performance can be an outcome of mere luck and the data that might be used is statistically insignificant. There is no straight forward answer to the question "whether you should or shouldn't fire your advisor" as there exists no set framework for determining the same. We shall still try and bring out a few overlooked and a few overhyped parameters which will help you come to the conclusion for yourself.

Performance – The most abused metric:

Although most of the advisor client discussion revolves around performance, there is absolutely no way to statistically and correctly determine the right advisor who can generate alpha continuously. *For e.g.* if you have a population size of 25 (that is you have 25 Advisors to select from) and you need to have a confidence level of 95% (let's say a largely statistically significant confidence level) and confidence

interval of 5(the margin of error), then you must evaluate 24 advisors (sample size) to be able to arrive at the right or wrong advisor for you. That's tedious but manageable with a little bit of effort.

Also the amount of data you will need to evaluate the performance is really overwhelming. Let's say we again take a 95% confidence level to be sure of the outperformance capability of the advisor/fund manager. Let's say the expectation of outperformance of returns is 3% over benchmark and volatility of returns (standard deviation of alpha) is 10% then we need at least 44 years of data points to be sure of the advisor's capability to generate returns. Alas, however there doesn't exist any advisor with that kind of track record, at least in India. (Refer; Student's t-test conducted in 1908 by William Sealy Gosset for detailed methodology). Hence if the performance track record is not long enough it's very difficult to ascertain whether it's skill or just a fluke because of the statistical noise. It doesn't get more scientific than that.

However, to explore the point further let's say for limitation of data we decide that we go with the Investment advisor who has selected the best performing scheme in their model portfolio today. Exhibit below shows the pitfall for such kind of approach:

Scheme Name	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015R	2015	2016	CAGR*	Value of Rs 1000*
SBI Contra Fund - Growth	SCF	RV	RV	SCF	SCF	SME	SME	UE	TIGF	HGF	UT100	TIGF	IPT100	RV	5	BSA	IPT100	22.7	26,337
Reliance Vision - Growth	TIGF	SCF	TLC	TLC	RV	SCF	HGF	IPT100	SCF	FIB	FIB	HLC	TLC	BSA	2	SME	TIGF	22.0	24,062
Templeton India Growth Fund - Growth	RV	HGF	HGF	HGF	IPT100	FIB	LME	HGF	BSA	HLC	SME	IPT100	BSA	SCF	1	TLC	HGF	19.1	16,498
Franklin India Bluechip - Growth	IPT100	FIB	TIGF	BSA	JME	RV	SCF	FIB	SME	TIGF	UE	SCF	UE	TIGF	2	FIB	BSA	19.1	16,433
HDFC Growth Fund - Growth	FIB	UE	FIB	FIB	HLC	HGF	TIGF	TLC	UE	UE	UM	UE	UT100	UE	1	UE	FIB	18.4	14,956
Tata Large Cap Fund - Reg - Growth	HLC	HLC	SCF	UT100	TLC	JME	UM	UM	FIB	TLC	IPT100	RV	UM	JME	0	UT100	SME	17.9	13,862
ICICI Prudential Top 100 Fund - Growth	UE	JME	BSA	UE	SME	TLC	RV	RV	HLC	SME	HGF	BSA	SME	HGF	(0)	SCF	HLC	17.2	12,691
UTI Equity Fund - Growth	UM	TIGF	UT100	UM	BSA	IPT100	TLC	TIGF	RV	UM	TLC	SME	LME	UM	0	TIGF	RV	16.7	11,897
Birla Sun Life Advantage Fund - Growth	HGF	UM	JME	HLC	FIB	HLC	BSA	SCF	TLC	IPT100	LME	JME	HLC	SME	(0)	HGF	UM	15.7	10,361
SBI Magnum Equity Fund - Growth	BSA	IPT100	UE	RV	UE	UT100	UT100	UT100	HGF	LME	BSA	TLC	FIB	LME	(0)	UM	UT100	15.3	9,735
UTI Top 100 Fund - Growth	UT100	LME	IPT100	JME	TIGF	TIGF	FIB	HLC	UM	BSA	RV	HGF	RV	IPT100	(1)	JME	SCF	14.3	8,543
UTI Mastershare - Growth	TLC	UT100	SME	TIGF	HGF	BSA	UE	SME	IPT100	RV	SCF	LME	JME	UT100	(1)	IPT100	TLC	14.5	8,509
HDFC Large Cap Fund - Growth	LME	TLC	LME	SME	UM	LME	JME	LME	UT100	JME	HLC	FIB	TIGF	FIB	(2)	RV	LME	13.4	7,508
JM Equity - Growth	JME	SME	HLC	IPT100	UT100	UM	HLC	BSA	LME	UT100	TIGF	UM	HGF	TLC	(5)	HLC	JME	11.4	5,621
LIC MF Equity Fund - Growth	SME	BSA	UM	LME	LME	UE	IPT100	JME	JME	SCF	JME	UT100	SCF	HLC	(8)	LME	UE	10.4	4,907

*Performance Source: ICRA MFI Explorer, Performance data used from Jan 2001 to Dec 2016. Performance comparison done for illustration only. Not to be construed as investment advice.

Let's say the advisor recommends (on the basis of 2001 data) to invest in the best performing scheme for that year (let's say the scheme is denoted here as SCF) come 2016 and the scheme would be just a tad above the lower quartile of performance with a difference of 8.33% compounded underperformance over the best scheme for 15 years. You should have fired the advisor in the first year itself but the true data presented itself after 15 years and by that time the battle was already lost. Firing an advisor for short-term underperformance is the worst mistake one can do. For example Berkshire Hathaway over the last eight years has lagged the S&P 500 by 2.7 percentage points a year on an annual basis(source: marketwatch.com). If we thought that eight years was a good enough time to evaluate performance, we would have fired Warren Buffet as an advisor, which would have been a disaster.

If performance is not the evaluation criteria, what is?

The Human element of Advise:

Investment advisory is a people centric business after all. If you have respect for views of your advisor then you're most likely to take the advice seriously and implement.

The essential element of building reputation comes from consistency and simplicity of the communication received from the advisor. If the advisor is jargoning you out to make a point, most likely, it is a bad advice in the garb of good English. Advice should be simple, easy to make sense of. If you ever hear promises of supernormal returns with lowest possible risks, you're most likely going to end up with supernormal risks and lowest possible returns. Respect for each other's views should never be lost at any point in the advisor-client relationship.

Survival Risk Metric: Devil is in the details

While selecting the advisor we seldom question the process details and are just too lopsided by their recent short term statistically insignificant performance, assets under advisory/service etc. Seldom is the question on process, risk management and alignment of interest discussed. Tick box method of evaluation doesn't work in such a serious selection. If there is any reason to fire the advisor it should not be because of sticking to the outlined process and risk management expectations.

If your risk profile is X and the products in your portfolio are Y, you definitely need to ask the advisor to take a walk immediately. Take example of rogue derivatives trader Nick Leeson, who lost ~1BN USD which eventually led to the collapse of the Barings Bank in 1995. A failure to understand and acknowledge operational risk is a far higher risk than understanding market risk as systemic failures which can destroy wealth in no time.

Sincerity Metric; Owning up mistakes in the same stride as touting about successes:

No advisor can be right or wrong all the time. Most advisors want to highlight the winners and downplay the losers. It might be prudent to evaluate the advisor based on the losses more than the wins. All losses come with learning, and the advisory process can only be as robust as the feedback and corrective action taken based on the learning. Owning mistakes comes from humility which is also an important part of the learning process. There might be high conviction in long term but there may be underperformance in the short-term, but its best if the advisor is ready to own it up, back the judgement with reasonable amount of rationale and ensure that the thesis holds in spite of the noise. Humility is good, however if the advisor lacks conviction, that is a recipe for disaster. Remarks like these "times are different ", "turnaround is just around the corner", "earnings will follow" without any evidence of so happening do little but just lip service. Sincerity is one of the most overlooked metric.

The Calming Effect

One of the most important part the advisor has to play is during the tough times when the heart takes over the mind. One of the most important qualities that your advisor should have is to calm those nerves when there is uncertainty. It is imperative that you test the advisor behaviour under these extreme scenarios. A recipe for disaster is an advisor who is equally incapable of handling volatility. If your advisor is bad at handling stress scenarios it’s time to part ways. Please note however that stress events by design happen very infrequently and hence this parameter gets rarely judged.

Summary:

To sum up, there is a higher attention that we put to performance metrics while evaluating an advisor and little or no attention is paid to other more important parameters discussed above. We need to align to the fact that returns are an aggregate of and a function of all these process points. One cannot evaluate the outcome because of the statistical noise, however, one can definitely be vigilant about the input variables which can be controlled, monitored and improvised upon.