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# HOW TO CONTINUOUSLY MONITOR & EVALUATE YOUR FUND MANAGER

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In an article published last week, I explored the process of selecting fund managers based on clients' unique needs. However, manager selection is only the first step in the broader investment management process.

Once a manager is chosen, continuous monitoring is necessary to ensure they remain aligned with the investor's objectives and perform as expected.

This article will focus on the ongoing evaluation of fund managers, key portfolio considerations and the importance of robust due diligence in safeguarding the investor's interests.

## THE IMPORTANCE OF CONTINUOUS MONITORING

Hiring a fund manager is not a once-off task; it is the beginning of an ongoing relationship that requires regular review and scrutiny. As financial markets and economic conditions evolve, so too must the strategies employed by fund managers. Regular monitoring of these strategies helps ensure that the manager continues to deliver on the investor's objectives.

One common issue that arises over time is return dilution. This occurs when a manager, particularly one with a strong track record, experiences significant growth in their assets under management (AUM).

As the fund grows, it can become more difficult for the manager to invest additional capital effectively without diluting the potential returns.

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To address this, managers often shift focus to larger, more liquid securities or increase the number of holdings. While this can help manage risk, it may also result in performance that closely tracks the market index, reducing the possibility of generating excess returns, often referred to as “alpha”.

**When monitoring a manager, it is important to assess whether they are still following their stated investment philosophy and whether their strategy remains appropriate for the investor’s goals.**

A significant deviation from their original strategy may indicate that the manager is responding to short-term market movements, which could be detrimental to long-term performance.

## PERFORMANCE REVIEWS: BALANCING QUANTITATIVE AND QUALITATIVE FACTORS

The decision to retain or replace a fund manager should be informed by both quantitative and qualitative assessments. Quantitative measures such as performance metrics, alpha generation, risk-adjusted returns and tracking errors relative to the benchmark are essential components of this review. However, over-reliance on short-term performance figures can be misleading. Markets are cyclical, and even the best managers may underperform for short periods.

**For this reason, qualitative factors are equally important. These include an assessment of the manager’s investment philosophy, the consistency of their decision-making process and their ability to manage risks effectively. A key question to ask is whether the manager’s investment philosophy and strategy have remained consistent or if there have been significant changes in response to recent market trends.**

Managers who frequently alter their strategies in reaction to short-term performance may lack the discipline needed to deliver long-term results. Additionally, qualitative analysis should include an evaluation of the operational health of the investment firm. Even if a manager has a solid track record, operational issues such as weak governance, inadequate resources or compliance failures can undermine their ability to continue delivering positive results. Investors should ensure that the firm behind the manager is well-structured, properly resourced and capable of supporting the manager’s long-term performance.

## THE ROLE OF DUE DILIGENCE IN MANAGER EVALUATION

**Due diligence is the cornerstone of sound investment decision-making and should be performed, not only before hiring a manager, but also throughout the investment relationship.**

Investment due diligence focuses on understanding whether the manager’s investment process is repeatable and consistently implemented. This includes examining the underlying assumptions that drive the manager’s strategy and how they have performed under different market conditions.

**A well-structured due diligence process helps to ensure that the manager’s historical performance is an accurate reflection of their abilities and not simply a result of favourable market environments that may not repeat.**

Operational due diligence is equally important in assessing the structural integrity of the investment firm. This includes evaluating the firm’s policies, procedures, governance structures and the adequacy of its personnel. A strong operational foundation reduces the likelihood of operational risks such as fraud, compliance failures or business disruptions.

## BEHAVIOURAL BIASES IN MANAGER SELECTION AND MONITORING

Investors are not immune to behavioural biases, and these can significantly influence the process of selecting, monitoring and replacing fund managers. One common bias is the tendency to favour managers with strong recent performance, known as “recency bias”.

Investors may be tempted to replace managers who have underperformed in the short term, even if their long-term outlook remains solid. Conversely, investors may hold onto managers who have performed well recently, even if there are signs that their performance may not be sustainable over the long term.

Another bias is the “representativeness bias”, where investors make decisions based on stereotypes or overly simplistic evaluations. For instance, a manager’s charisma, presentation skills or past reputation may lead an investor to overlook potential weaknesses in their strategy or process. This bias can result in poor decision-making if investors fail to properly assess a manager’s actual ability to generate returns.

**To combat these biases, investors should implement a systematic process for evaluating managers. This process should include a combination of quantitative analysis, such as performance metrics and risk-adjusted returns, and qualitative assessments, such as the manager’s philosophy and operational structure. By taking an integrated approach, investors can avoid the pitfalls of over-relying on recent performance or making decisions based on subjective impressions.**

## PORTFOLIO CONSIDERATIONS: RISK BUDGETING AND DIVERSIFICATION

**As part of the ongoing evaluation of fund managers, investors should regularly review the overall structure of their portfolio. When employing multiple managers, it is essential to ensure that the portfolio remains well-diversified, and that risk is distributed appropriately across asset classes and strategies. This process is known as “risk budgeting”. Risk budgeting involves allocating risk where it is most likely to be rewarded.**

For example, an investor may decide to take on more risk in equities or alternative investments, while maintaining a more conservative approach in fixed-income or cash holdings. Each manager or strategy within the portfolio should contribute to the overall risk-return profile in a manner that aligns with the investor’s goals.

However, investors must be cautious not to over-diversify by employing too many managers or strategies with overlapping exposures. While diversification helps to manage risk, excessive diversification can dilute potential returns.

## THE COSTS OF REPLACING MANAGERS

**There will be situations where it becomes necessary to terminate a manager and replace them with a new one. However, this decision should not be taken lightly, as it involves both direct and indirect costs.**

Direct costs may include transaction fees, taxes on realised gains and potentially higher fees charged by the new manager. Indirect costs include the time and effort required to find and evaluate a new manager, as well as the potential for portfolio disruption during the transition period.

The net expected benefits of replacing a manager must outweigh these costs. While the costs are immediate and quantifiable, the benefits, such as improved performance, are often uncertain and may not be realised for some time.

Investors must weigh the certainty of these costs against the potential long-term benefits of hiring a new manager. In some cases, it may be more prudent to retain an underperforming manager if the costs of replacement are expected to exceed the potential gains.

## CONCLUSION: ALIGNING INTERESTS AND ENSURING TRANSPARENCY

The ongoing relationship between an investor and a fund manager relies on trust and transparency. Managers must be able to clearly communicate their strategies, the risks involved and the factors driving their performance.

If a manager cannot explain their investment decisions in a clear and consistent manner, it may raise red flags about their ability to deliver on their promises.

Ultimately, successful investment management involves finding the right balance between risk and reward, cost and benefit, and diversification and concentration. By employing a systematic approach to evaluating and monitoring managers, investors can make informed decisions that align with their long-term objectives.

**ROBUST DUE DILIGENCE AND THE CAREFUL MANAGEMENT OF BEHAVIOURAL BIASES ARE ESSENTIAL TOOLS IN THIS PROCESS, ENSURING THAT INVESTORS PROTECT THEIR INTERESTS AND OPTIMISE THEIR PORTFOLIOS OVER TIME.**



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Marise has been a financial adviser in our Pretoria office since April 2015. She was recognised as Brenthurst’s Top Financial Adviser in 2020, receiving the Brenthurst Award of Excellence. She obtained BCom Investment Management & BCom (Hons.) Financial Management degrees from the University of Pretoria. She also obtained a Post Graduate Diploma in Financial Planning from the University of the Free State.

Through practical experience and appropriate qualifications, she can advise clients on all investment related matters, focusing on pre-and post-retirement planning as well as offshore investments. Marise is a CERTIFIED FINANCIAL PLANNER® professional and is fully qualified to give advice on all investment matters.

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