



## Avoiding “Manager Risk”

Today's  
5 star  
Fund  
manager  
could  
leave you  
high &  
dry and  
become  
tomor-  
row's  
hedge  
fund  
Super-  
star!

## Sails setting on the “Clipper” ship!

### *Avoiding the perils of “Manager Risk”*

When you buy a mutual fund, one smart strategy often suggested to investors is to look for a fund that's run by its founder. It's even better if the founder has a good, long-term track record, follows a disciplined, consistent investment strategy, communicates well with shareholders, and has a significant amount of his own money invested in the fund. For over 15 years, that description fit the Clipper Fund to a “T”. But things change! While we were smart (*or lucky*) enough to spot a dramatic change that occurred at Clipper about 12 months ago and get Northstar clients out of Clipper, it's very hard to stay on top of things when there are more mutual funds than NYSE listed stocks.

As for the “smart strategy” - forget it! Thousands of individuals followed exactly this advice, invested in the Clipper fund, and now those people have been left out at sea. Clipper founder James Gipson, announced last month that he's quitting the fund at the end of 2005. Also heeding Gibson's cry to “abandon ship” are two other long-time, key members of the Clipper management team. All three are headed for – would you believe it? - a hedge fund.

Perhaps the issue raised by the Clipper fund is a much broader one, highlighting the important (and seldom-discussed) subject of “manager risk.”

“Manager risk” isn't a difficult concept to grasp... When you invest in an actively-managed fund, you're betting on the skill (or luck) of the fund's manager, and when the manager leaves, you face at least two possibilities for a loss.

First, if you choose to bail out of your fund when your manager does, and your shares have built-in capital gains, you lose part of your investment to capital gains tax (this assumes, of course, that you own the fund in a taxable account).

Second, if you stay with the fund, and the new manager isn't as successful as the previous manager, you suffer a potential opportunity loss, since you might have earned a better return by moving to new fund.

Often, both alternatives -- leaving or staying -- are not attractive and the departure of your fund manager forces you into an unwanted and often uncomfortable investment decision (or no decision at all, which is the same thing). The

story at Clipper tells us that no actively-managed fund can be considered immune from manager risk..... Today's entrepreneurial founder could be tomorrow's sell-out, or today's star employee/manager could be tomorrow's hedge fund superstar, getting 2% management fees, 20% of any profits with virtual immunity from regulatory oversight. Sweet!

Adding manager risk to all the other risks faced by investors does not seem to make sense for investing in efficient markets. “Efficient” means that it is very difficult – if not downright impossible – for a manager to consistently offset their fees and still beat their market benchmark. Rather, investing through use of a low cost, low turnover asset class funds like DFA, index funds like Vanguard or exchange traded funds (ETF's) can eliminate manager risk. This approach allows investors to capture asset class market returns (less a very small fee for index fund management – typically around 0.15%-0.25% per year) without manager risk.

Northstar's investment philosophy and focus on DFA and other similar funds has saved our clients many headaches and unwanted tax surprises over the years!