

401(k) ADVISER

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Investment managers can go from zero to hero over time



The extreme stock market volatility of the past twelve months has underscored a fundamental truth of investing. No investment manager should be expected to outperform the market all the time. The good ones simply outperform more often than they underperform.

By the end of 2008, conservative investment managers were the toast of Wall Street as they had seemingly anticipated the market downturn and preserved capital in one of the most difficult equity markets on record. Nine months later, most of these same investment managers are meaningfully underperforming the market.

Conversely, a number of well-known investment managers who underperformed the market in 2008 saw their results soar well above the recent stock market rally in 2009. What are we to make of these investment managers who have gone from hero to goat, or goat to hero?

Even the best investment management organizations, with stellar long-term track records, experience periods of dramatic underperformance. Sometimes these periods can last a year or longer.

To help quantify the degree and frequency with which talented investment managers underperform, we can use the data provided in a study released last summer by Robert W. Baird called, "The Truth about Top-Performing Money Managers." In this study, Baird analyzes the performance history of just over 500 actively managed U.S. equity mutual funds that outperformed their peers by at least one percentage point per year on average over the previous 10 years.

A study of these top-performing funds' previous 10-year performance history yielded the following data:

* 90% underperformed their average peer for at least one three-year period.

* On average, these top performers spent more than 20% of the previous 10 years with trailing three-year performance below their average peer.

* 66% underperformed so severely they found themselves in the bottom quartile of their peers on a rolling three-year basis.

The Baird study clearly demonstrates what many have witnessed with their own mutual fund holdings over the past twelve months. Top-performing investment managers periodically underperform their peers over short-term periods.

Dip can be opportunity

These findings illustrate how misleading short-term performance can be. As tempting as it may be to bail out of a fund that has underperformed for a year, that is quite often not the correct action to take.

In fact, one interesting conclusion that can be drawn from the Baird study is that short-term underperformance by high-quality investment managers is more likely an indication of a good time to buy than a reason to get out. Looking at the top-performing funds through the lens of Morningstar's star-based rating system, a primarily performance-based ranking system, the funds in the Baird study that were downgraded by Morningstar from 3 stars to 2 stars actually outperformed those that were upgraded from 4 stars to 5 stars (3.8% outperformance vs. 2.5% outperformance after ranking change) during the 10 years of performance history they evaluated.

Let's be clear, this is not an argument for looking for the worst-performing mutual fund you can find. Often, underperformance is evidence of an investment manager with qualitative problems. Issues such as turnover in investment personnel, a change in ownership structure or radical change in investment strategy can ruin what was previously a good investment product.

One might also be tempted to say these findings argue for sticking with index products. Why not just earn the broad market's results, less a small management fee, and not ever worry about underperforming again?

We believe index funds have their place in almost every 401(k) menu of investment alternatives. But we also believe there are simply too many investment managers who have demonstrated their ability to outperform in good times by more than they underperform in bad and in the end add significant value.

Consistency important

The best investment managers are those who consistently apply a time-proven method for deciding which securities to buy and sell. Yet the past twelve months stand as a stark reminder that the forces moving the markets change without warning. An investment manager consistently applying the same investment discipline through radically changing economic periods will often experience radically different performance relative to its peers. In other words, there are times when a top-performer's investment discipline is in sync with the market, and times when their approach is not.

Our research suggests that diversifying your team of investment managers by investing with organizations that utilize different investment styles lowers overall portfolio risk. Avoiding the temptation to chase "hot" funds will also help to lower overall portfolio volatility. Most importantly, recent market volatility has demonstrated the need for patience when evaluating investment manager performance.

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