

The Emperor's New Funds – Part 1

The World is not Flat

DISCLAIMER: The early portion of this thought piece might sound like an indictment against active investment management. Nothing could be further from the truth. Please read until the end to see how much value can reliably be gained from active investment management.

Somewhere along the way, someone must have gotten out a very large piece of granite and chiseled in it the “right” way to purchase mutual funds. It has a simple three step approach:

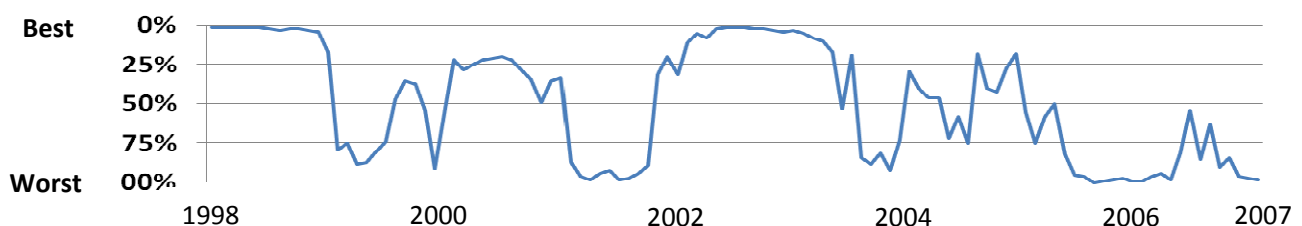
1. Spend a lot of time and thought in selecting the right mutual fund;
2. Only use one mutual fund for each asset class (e.g. large cap growth domestic equity);
3. And hold onto this fund for as long as possible (or until it “blows up”).

This approach has been the default model for a long time. Virtually everyone uses it, including investors and investment professionals. And why not, it has been carved into granite. In fact, most of the investment management industry has been built upon the premise that this model stays in place. Their profit engine counts on it, their organizational and sales model requires it, and almost everyone accepts it. There is just one little problem with this Golden Oldie – it really doesn't work very well for the investors. It works brilliantly for the mutual fund companies, but the evidence increasingly shows that the buy and hold approach to funds has a very low probability of working for the end investor.

The fly in the ointment is something that is known as investment managers' AlphaCycle. This term refers to the fact that the best managers in the world deliver their performance through a rolling series of significant outperformance followed by a period of material underperformance. To highlight this concept, take a look at the performance of one of the best performing and most widely recognized investors in the country: Bill Miller, the fund manager of the Legg Mason Value (Primary Class).

In Figure 1 below, you can see 10 years worth of rolling 12 months performance, from 1998 through 2007, of Mr. Miller's fund as compared to the performance of the entire Morningstar mutual fund peer group that the Legg Mason Value fund competes against (large cap blend). The vertical axis represents the 12 month ranking of the fund within the peer group (a ranking of 1% represents best performance, a ranking of 100% means worst), the horizontal axis represents time. As you can see, the fund cycles through periods of remarkable excellence, followed by periods of significant underperformance.

FIGURE 1 - Legg Mason Value (Primary Class); Rolling 12 Month Relative Performance within Peer Group



Why is this? It reflects the manner in which investment managers deliver their results. For a manager to successfully stand out from the crowd, to beat the hundreds of competitors by enough to earn investors' attention and industry accolades, the manager must make some bets. If you want to lead the herd, you can't be the herd.

As we all know, the investment markets tend to have a mind of their own. They never stay constant. Therefore, this approach works great – until it no longer does. Bets that were paying off handsomely at one point in time eventually no longer do, and the once-high-flying manager is now looking up to most of their competitors – and investors are holding on for the ride. This is the definition of AlphaCycles.

The fact that AlphaCycles exist does not mean that active managers do not add value. Top managers like Mr. Miller spend enough time at the top of the peer group to more than make up for the time spent underperforming. Purchasing his fund in 1990 and holding the fund through the end of 2007 would have resulted in a gain of 705% versus only 508% for the S&P500.

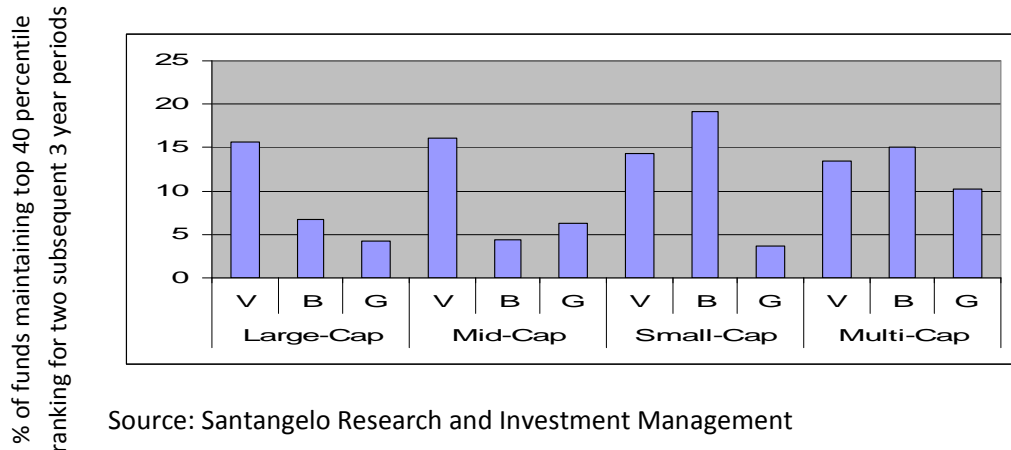
But there is a “but” coming. Go back to that piece of granite with the “right” way to purchase mutual funds. If you flip it over you will see taped to the backside a piece of paper with a big asterisk on it. It reads:

1. It is remarkably hard to know *in* advance which funds are going to add huge value over a long time period, and
2. Most investors buy when a manager is at the peak of their AlphaCycle, and sell as soon as the going gets rough.

In fact, the odds are very long against a *traditional buy-and-hold strategy* working for investors. Some of the most powerful research ever produced regarding the viability of long-term fund performance comes from Santangelo Research and Investment Management, the firm founded by Ron Santangelo of Merrill Lynch fame. They conducted a study that grouped U.S. equity managers into quintiles based on rolling 3-year performance within their Lipper investment objective group. The top two performing quintiles (top 40%) were then looked at to determine which managers were able to remain as a top performer (i.e. top 40%) over the subsequent 3-year period.

The beauty of this research is its relationship to industry behavior. A fund needs to perform well over at least a 3-year period in order to be under consideration for purchase by virtually any professional model. Thus the first 3-year window is where a fund is “screened in”. The second 3-year window is when an investor owns it. This is the only time period that really counts to them. Thinking about the AlphaCycle phenomenon gives everyone a huge heads up to where this research comes out. Of the 12 capitalization and style categories evaluated, on average only 10.8 percent of top performing managers from the first period maintained their status over the ensuing 3-year period (see Figure 2). The *best* level of persistency was 19.1 percent for small cap blend funds, and the worst was 3.6 percent for small cap growth.

FIGURE 2



Source: Santangelo Research and Investment Management

Therefore, an average investor, using the *buy-and-hold strategy for funds*, has about a 1-in-10 chance of success. So what is an investor to do? The answer is actually very straightforward – simply reject the legacy approach of long default holding periods for funds! There is an alternate approach that is both readily accessible and far superior.

While F-Squared Investments doesn't ever put investment methodologies into granite, we do espouse a decidedly different set of steps for accessing active investment management, and our research shows us that this modified version can make a massive improvement in a client's return:

1. Spend a lot of time and thought in selecting the right managers;
2. Select multiple managers for each asset class (e.g. large cap growth domestic equity), resulting in an extra layer of diversification at the manager level (we use up to 10);
3. Use only a 12-month default holding period, forcing manager rotation for underperforming managers annually;
4. Cut fees aggressively.

As proof to the improved returns available from this approach, this four-step model is the basis for constructing the AlphaCycle Indexes of actively managed mutual funds (www.activeindexsolutions.com). There are 18 such Indexes and while most have track records back to 2002, several have track records starting in 1997. The American Stock Exchange publishes Index values on a daily basis for all 18 Indexes.

These Indexes, compared on a rolling three-year, gross of fee basis versus appropriate benchmarks, delivered a 78% outperformance versus their traditional passive benchmarks (such as the S&P500), and a 91% outperformance versus Morningstar mutual fund peer groups. The symmetry is beautiful. Santangelo's research indicated that average fund has effectively a 1 in 10 chance of success. The AlphaCycle Indexes have generated a 9 in 10 chance of similar success.

Active management can work, and investors can gain access to it in a manner that allows them to capture excess return. The first step is to simply reject the decades-long paradigm of single manager and long holding periods. After all, it wasn't too many centuries ago that everyone "knew" that the world was flat.

Howard Present
F-Squared Investments

Visit our website at www.f-squaredinvestments.com to learn more about AlphaCycle Investing, AlphaCycle Indexes, and investment products that are built to track the AlphaCycle Indexes.

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