



How To Fix Your Investment Strategy

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In this article we will focus our discussion on mutual funds as they are the most popular investment vehicle in America today. Most of what we say is equally applicable to investors who have placed their money with a money manager or have selected a group of managers through any of the major brokerage's managed account programs.

The bad news first.

Despite what you might see in Money magazine or hear at dinner parties, most people don't do very well investing in mutual funds. Few investors are aware of exactly how bad the average investor fares despite the performance track record of their mutual fund. DALBAR is a consulting firm that has been studying investor returns in mutual funds since 1984. According to the DALBAR web site, from 1984 through 2002, a period where despite the crash of 1987 and the bear market of 2000 through 2002, the S&P 500 has produced an annual return of 12.2%. The average return to stock mutual fund investors has been 2.57%. During this same period inflation averaged 3.14%, meaning on a real return (after tax and inflation) basis the average stock mutual fund investor lost money.

You may be asking yourself how is this possible? It is very important to understand that a performance track record is one thing and investor returns is another. Peter Lynch, the famous Fidelity Magellan manager who from 1977 to 1991 averaged 18% annual returns, was asked how the average Magellan investor fared? He responded they broke even. What Mr. Lynch was saying is that for every investor who stayed put and realized his long term returns, there was another investor who would to some extent or another and maybe without even realizing it attempt to market time his fund. The hapless investor would watch the share price rise from \$15 per share to

\$20, then buy. A market pull back would occur and the unsuccessful investor would sell at \$17. For every investor that earned 18% there was another that lost 18%. Cumulatively the average investor broke even.

DALBAR concludes, investors unsuccessfully chase returns and prove to be very poor market timers. Is DALBAR right, is the problem fully the individual investors fault? We believe that answer is only partially true. We think the problem is also structural to the money management industry and investors deserve a more detailed answer.

The mutual fund industry has flourished despite the mixed results for investors. When 1970 began there were 2,200 stocks actively traded on the New York Stock Exchange. There were 269 mutual funds and they managed total assets of \$48 billion. Today there are 2,600 stocks actively traded on the New York Stock Exchange (up 18%). There are over 9,000 mutual funds (up 3,345%) and they manage over \$7 trillion (up 14,500%) This is quite amazing when you consider about half of the participants don't have a very positive experience.

We think it is interesting to consider that the same development that fueled the phenomenal growth of the mutual fund industry may also be the fundamental flaw in the product. To understand our point we need to go back to before 1970.

In the 1950s and 1960s portfolio theory became a hot topic in the most prestigious business schools in America. This period marked the birth of what today is referred to as Modern Portfolio Theory (MPT). The foundation of MPT is two pillars and the conclusion was not

good news for the mutual fund industry. (for a more detailed discussion of MPT see *An Overview of Modern Portfolio Theory* in the Resource Center at sectorquant.com)

The first pillar is asset allocation (diversification) among asset classes (stocks, bonds, real estate...) is the most important factor that determines investor returns. The second pillar is that stock prices are random and efficient. Risk was equated with volatility and diversification was the only tool to manage risk. The conclusion was that professional management did not add any value. The academics pointed out their conclusion was supported by the fact that during the late 50s and throughout the 60s (as today) most professional stock portfolio managers did not perform as well as the S&P 500 stock index created in 1957.

This was not good news for the mutual fund industry. First, the fund industry would be hard pressed to justify the management fees they were currently charging due to their lack of performance. Second, there would be slim pickings offering the public index funds since one can't charge a management fee to administer an index fund only a small administration fee. Lastly, how many funds based on the same index does the county need? The future was not looking very bright. It was time to get some outside advice.

The Consultants Ride to the Rescue.

An anecdotal truth that supported the mutual fund industry up to this point was the observation that the market went through "seasons". During one season big company stocks would do better than small company stocks. During the next season the opposite would occur. There was then, as there are today, hazy categories labeling a stock either a "growth" or "value" stocks (see Wall Street Secrets-7 Things You Need to Know). And

Style Box-Sub Categories

			Size
			Large
			Medium
			Small
Value	Blend	Growth	Investment Valuation

like big stocks versus little stocks the market would go through seasons where it favored one style (value) and the next season it would favor the other style (growth).

We say this truth sustained the mutual fund industry because when a managers style (Small Growth) matched the market season (Small Growth in favor) the results would be fantastic returns that far exceeded the market averages. Not only would the fund grow its assets under management it would draw in new money and the fees to the fund company would soar.

Creating Sub Categories

The consultants had an idea. If MPT says you can reduce risk and enhance returns by blending asset classes and we as stock market insiders know the market goes through seasons (big company, small company, growth, value) why not create a specific mutual fund (sub-categories= 9 style boxes) for each season. The consultants went on. If the market is random and efficient clients don't need just one mutual fund they need 6 to 10 funds. Even better as market seasons change

clients will always have a winner and the fund company will always have one fund with a stellar track record to promote.

It is interesting how one idea can change the world. One moment the industry was pressed to justify its existence and the next minute they had justification to offer mutual funds in every conceivable category.

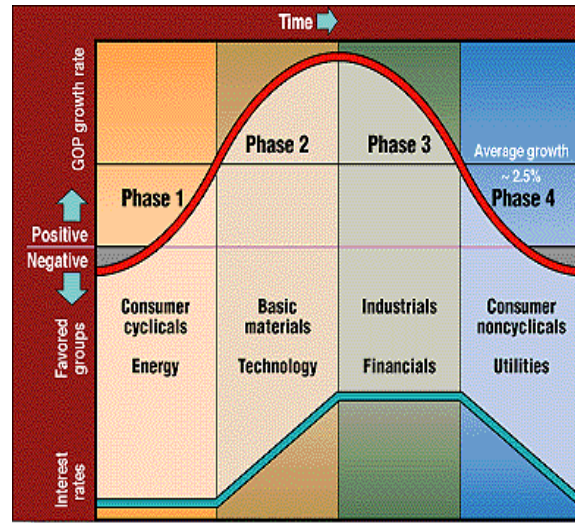
Can it be proven that blending an actively managed growth style fund with an actively managed value style fund reduces risk and enhances return? In one word, No. There is no universal definition of growth or value. If we surveyed 50 value style managers we would get 50 different definitions of what value investing is. The same exercise would get the same result with growth managers.

To take it one step further we will argue that taken in their purest form both growth and value styles of investing suffer critical defects. Pure value investing, buying the cheapest stock based exclusively on traditional fundamental measures (price to; sales, earnings, book value...) fails to look into the future. Discounting the future is a primary attribute of the stock market. Pure growth investing, paying any price for superior future growth, fails to pay enough attention to price.

In the quantitative study of the market presented in *What Works on Wall Street* by James O'Shaughnessey the result showed combining growth and value characteristics produced the best results. The problem is despite the latest and we feel the most comprehensive research, today almost all mutual funds and most money managers are sector and style specific.

Changing Seasons

Every market period is defined by which sectors are in or out of favor (In Favor: mid 80s large cap value, early 90s small cap growth,



late 90s large cap growth and technology, early 2000s small and mid cap value...). Market periods are persistent averaging 2 to 4 years. The chart above is not a road map but should be taken as an illustration that both the stock and the bond markets go through seasons that are loosely correlated with the business cycle. As Mark Twain said, "History does not repeat but it does rhyme."

Selling Performance

In 1991 Morningstar introduced its "star ratings" system. By 1994, 75% of all new investment into mutual funds went into funds with 4 or 5 star ratings. The ranking system is a composite risk adjusted return (beta)/absolute return calculated for 3, 5 and 10 year return periods. The overall star ranking is weighted average of these three time periods. In English, everyone buys 4 and 5 star rated funds.

These ratings are used by professional advisors (financial planners, brokers) as much if not more than by individual investors. The problem is if market seasons often last 2 to 4 years the best style loyal money managers will drop to a three star or lower ranking at the bottom of their out of favor season. A time we will argue the fund may actually most attractive. Conversely funds with less

management discipline will be most likely to achieve their highest ranking at the twilight of their in season period. The time we feel they are least attractive.

How many investors would buy a mutual fund with a terrible 3 or 5 year track record? How many investors actually shop for the best managed fund in the worst performing category? The industry sells and investors buy yesterdays performance. This is like trying to drive forward based on what you are seeing in the rear view mirror.

Looked at another way, investors often sell at the bottom. As the old expression goes, *It's always darkest just before the dawn*. Our experience as a financial advisors is that most investors can stomach a losing investment for a year. Somewhere between the 18th and 36th month most will abandon logic and sell in sheer frustration. The results speak for themselves.

In summary the worst investors usually jump in when it looks good (already up) and get out when it hurts (they are losing money). The opposite of buy low sell high.

Why most managers underperform.

We think the reason most stock mutual funds and money managers under perform the S&P 500 stock index is because they are style (growth or value) and sector (small, large, healthcare, utility...) specific. When they are in season the results are fantastic. When they are out of season the performance really suffers. The net result for investors is below average.

Strategic Asset Allocation

Owning a multitude of funds to represent a large number of sectors and styles (all the style boxes) is called Strategic Asset Allocation. Strategic Asset Allocation is the most popular investment strategy in the world and

lies as the foundation of the mutual fund industry. We find strategic asset allocation is inefficient at capturing the markets upside simply because it is rare for more than half of all sectors to be going up at the same time. Remember the great bull market-mania of the late 1990s was almost exclusively concentrated on technology. The own them all strategy is equally inefficient at managing downside risk during bear markets when most sectors are in-fact going down.

There is an expression about stocks that says a rising tide lift all ships. The astute observer notes, not at the same time or to the same extent. Conversely a declining tide hits the most overpriced hardest. But when the decline expands into a full fledged bear market only a few ships survive unscathed.

Our experience is bull and bear markets expand and contract. Some bull markets start out feebly with only a few groups moving to the upside. They then go on to surprise the bears as the bull market expands with more and more groups participating. Other bull markets start out robustly with a large number of groups participating then narrow as they mature. Bear markets develop in similar fashions.

Our point is that from both a managing risk or optimizing return perspective owning all the style boxes is simply not efficient.

A fixed approach to diversification and asset allocation, even indexing, fails to adjust to the market and economic cycle. A classic example of the error is to recommend older investors invest in less volatile value stocks and younger investors with longer time horizons invest in more volatile growth stocks. This strategy ignores the market and economic cycle.

There are common market factors (interest

rates, valuation, the economic cycle, earnings trends...) which influence the performance of entire asset classes.

How does one do better in the future?

Given the magnitude of the problem we propose a two step answer. First, managed investment programs (as opposed to day trading) is not the place for anyone who does not have a ten year plus investment horizon. Learning to stay put is the simple yet difficult first step. In our experience we find many people who intellectually understand the market will bounce around. But at some point the down bounce exceeds their threshold of pain and they are out at the bottom. These people should just avoid managed investment programs.

The next step to improve your investment experience is to find a money manager or adopt a strategy that is not sector and style specific. Adjusting to market seasons is critical to managing risk which facilitates commitment and the achievement of long term objectives. The most scientific and insightful research on the stock market and portfolio theory has been conducted in the most recent ten years. We say most scientific because it has been quantitative in nature by measuring the actual performance of different strategies. The results show the market to be seasonal and the best approach to achieve performance and manage risk is to blend disciplines and adjust to market seasons.

The problem is despite the body of quantitative research, style specific investing remains entrenched. Easily 90% of all mutual funds and a similar percentage of money managers are sector and style specific. We believe as the body of research grows this condition will erode, but with three decades of momentum reversal in the mutual fund industry will take time.



How is SectorQuant different from other money managers?

Most money managers are sector and style (large value, small growth, utilities, technology...) specific. Most money managers outperform when their style is in favor and underperform when their style is out of favor.

At SectorQuant our goal is to help our client achieve their long term objectives. SectorQuant strives to manage risk without limiting potential by adjusting to market seasons. We seek to overweight the attractive and underweight the unattractive groups in our client portfolios.