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*March, 2004*

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I would like to thank the 95% or more of my clients who have stayed with me through these difficult years from 1999 to 2003. It is a privilege to provide you with investment advice and help you look after your financial matters. I appreciate your patience. My business has grown through these years, and I am very thankful for that. I continue to accept new clients, primarily referrals from existing clients. Please note that in order to keep my service level at high standards, I am restricted to new accounts with greater than $250,000 of investments, however, smaller accounts can easily be accommodated in our office, so please do not hesitate to have someone call. My assistant Barb McKenzie will be happy to arrange a complimentary introductory meeting.

# Excellent Manager Project

One of the difficult situations that investors face is when even the great investment managers seem to 'underperform'. This article reports the results of some research that I have done on the performance of good investment managers.

First, what do we mean by 'under-perform'? Most mutual funds and pension funds calculate the rate of return on their investment portfolios for each calendar quarter, and then compound the returns over various periods such as 1, 3, 5, and 10 years. The returns are compared to various benchmarks including other managers in similar categories, and are ranked into quartiles from best (top quartile) to worst (4th).

These performance rankings (especially the quarterly ones) are the source of a great deal of noise in the investment world. Managers unfortunate enough to rank in the 4th quartile are roundly criticized by media and pension-fund consultants, (who both make a living, incidentally, by having investors anxious about their managers). As a result of this public flogging, the unfortunate 3rd and 4th quartile managers usually have their investors rushing for the exits.

Good examples of this are the Ivy Canadian Fund, our Assante Optima Canadian Value Pool, and the major Trimark Canadian equity funds in 1998 and 1999. The Ivy experience, analyzed in this newsletter *, was that the fund's return of 3.1% in 1999 landed it in the 4th quartile. This return looked particularly bad to some people compared to the tech stocks which looked so good at the time. The result was that investors pulled *more than one quarter of the total dollars* from the $6 billion fund. That's right - $1.7 billion was pulled from the fund between July of 1999 and May of 2000.

The wise investors who patiently waited were rewarded with a 20% return (top quartile) in 2000, and have had strong positive returns through the bear market. The Assante Optima and Trimark experiences are similar.

This story is extremely important. It illustrates a collective $1.7 billion mistake by investors in one fund alone – they pulled their money from the fund, just in time for the fund to post three great years. (You can guess where the money went, but my earlier research * indicates it went to the technology stock funds.) It illustrates what many important industry veterans believe is the greatest danger to investors – chasing last year's winners.

It also illustrates one of the most valuable and difficult functions that I provide as an Investment Advisor – keeping client portfolios on track so they do not become victims of the fashion or panic *du jour.*

The question I asked is, 'How frequently do managers with great long term records fall out of favor?' Are the Ivy, Trimark and Assante Optima examples above infrequent, isolated events?

To shed some light on the matter I had a look at the top managers in the main Canadian Equity mutual fund category over the 10 years ended December 2003. There are 116 Canadian Equity funds with 10 year records, according to Bell Charts, a performance analytics company.

(Note that I use the term 'manager' synonymously with 'mutual fund' here. Most of the mutual funds in the sample happen to have been run by the same manager for the 10-year period, but the effect of manager turnover can be the topic of another study.)

I then selected the top quartile of these managers over the 10 years. There are 27 managers in the top quartile; their ten-year average annual compound returns ranged from 9.6% to 16.2% per year. I'm happy to report that our Assante Optima Canadian Value Pool, managed by Dan Bubis, is solidly in the top performing group, as is the Ivy fund referred to above. Trimark is very close. Pretty good performance, given the conditions of 2000 to 2002, but not unreasonable in the context of history.

Next, I examined the performance of these managers in *each individual year* of their stellar 10-year records. Looking at the performance year-by-year provides rich insights into how the manager went about achieving the 10-year record. For instance, did the fund have one skyrocket year to bring a dismal average up, or was the manager in the top quartile every year of the 10?

What I found is that all 27 of these top managers were in the bottom half - 3rd or 4th quartile - *at least twice* in the 10 year period. A surprising 78% spent at least 3 years in the bottom half. Ten of the 27 managers (37%) spent *4 or more* of the 10 years in the bottom half.

All but 5 of the 27 top managers spent at least 1 year in the very basement – 4th quartile. Not only that, 7 managers (25%) spent an amazing 3 years in the 4th quartile – yet still managed to achieve top performance over the entire 10-year period. And the 5 managers who avoided the 4th quartile over the ten-year period didn't escape entirely: they were 3rd quartile 3 or 4 times.

In other words, almost everyone is in the cellar at some point. And *everyone* is in the bottom half of the pack a third of the time.

What's the lesson here? Do great managers temporarily lose their minds?

The lesson is that great managers *do not appear great all the time*. A chess master doesn't win all his games, and Tiger Woods doesn't win all his tournaments. The evidence shows that it is not uncommon for a great investment manager to spend one third of a ten-year period in the bottom half of all managers.

These periods of underperformance can result from specific decisions, such as in 1999 and 2000 when many value style managers avoided the tech stocks and appeared foolish when others seemed to be so smart. Apparent underperformance can also result from random events like the currency crisis in 1998, which knocked the bank stocks down 45% in 6 months, temporarily punishing fund managers that held bank stocks.

The really dangerous part of this is that periods of poor performance are very tempting for investors, whether they are pension funds or individuals, to 'fire the manager' by switching funds, which is usually the wrong thing to do, and can be disastrous. In fact, my clients know that I will frequently add to a manager who does not seem to be doing well.

The difficult part is that to be a successful investor, you need to stand apart from the crowd. And when you stand apart from the crowd, you might not look so smart for awhile.

Or, maybe the lesson is this: maybe achieving good returns over a long period of time isn't about avoiding all the bad years, or firing a manager who is having a bad year just in case he has another. Maybe not-so-good years are all part of the story, to be expected: normal things on the long journey to investment success. After all, life is a lot like that.



Questions? Comments? e-mail me at choran@assante.com or call direct at 416- 216-6532.

* "Investor Psychology", July 2000, available on my website at www.assante.com/advisors/choran/