

Evaluating Investment Manager Performance

The end of December is always a popular time for financial media to discuss the year's investment winners and losers. It is common to see lists of the best and worst performing stocks and mutual funds under eye-catching headings like "Hot Stocks" and "Top Mutual Funds." This year is no exception as we're already seeing many such lists in magazines and on the Internet. Topping the list in 2006 are funds that use leverage, or invest in China or gold. Interestingly, what is usually missing is a discussion about the risks of many of the top performers and perspective on their longer-term performance results. It is very unlikely that in 2007 the list of top performers will be the same as this year's winners.

In our April 2004 and November 2005 Commentaries (both archived on our website under the Monthly Commentary tab), we discussed the challenges of market timing and its impact on investors' returns. Unfortunately, for many investors, a focus on investments with the best short-term performance is not likely to lead to investment selections or behaviors that result in desirable long-term returns.

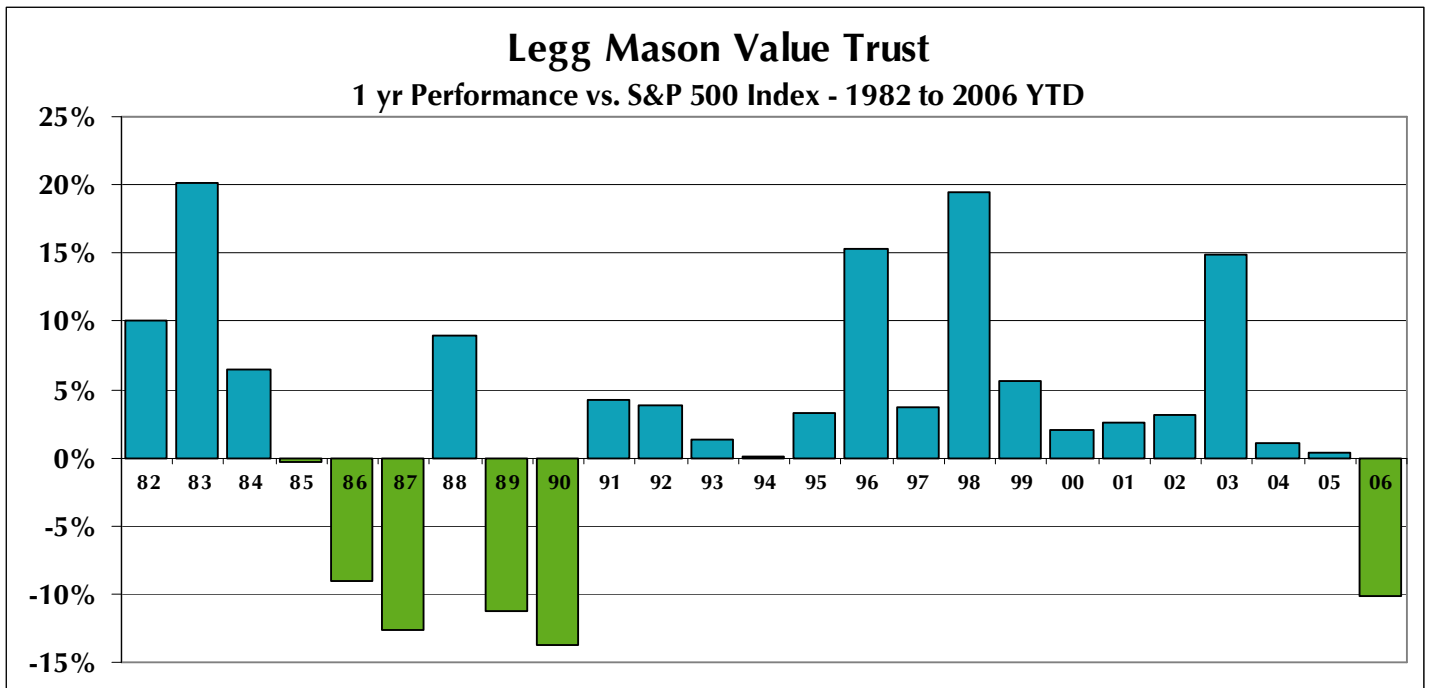
In addition to the best and worst lists, we often see unflattering articles about investment managers who have stellar long-term track records but have suffered from weak short-term performance. It seems that

investors, just like sports fans, are fascinated with performance streaks. A case in point is Bill Miller, the manager of the Legg Mason Value Trust. An article on CNNMoney.com displays the title "Bill Miller's streak nears an end - The legendary Legg Mason fund manager has beaten the market for 15 straight years, but a 'Sweet 16' celebration probably isn't in the cards." This article goes on to say "Streaks were meant to be broken. Joe DiMaggio couldn't get a hit in a 57th straight game. The UCLA men's college basketball team finally lost after 88 consecutive wins. And, barring a major miracle, Bill Miller's Legg Mason Value Trust mutual fund will not beat the S&P 500 this year, bringing an end to his legendary 15-year streak of outperforming the market." Another article questioned whether Miller is losing his "Midas touch."



At Madison Wealth Management we don't expect managers to turn everything they touch into gold. And, we believe that it is important to look beyond short-term performance when selecting an investment advisor or a mutual fund. Thus, it is important to have additional criteria with which to evaluate a manager. Certainly an evaluation of the longer-term results is important. But, even more meaningful is an understanding of the manager's investment philosophy and research process. For example, if the manager has a policy of avoiding companies that operate in cyclical industries like energy and chemicals, the performance could be drastically different from its benchmark when such industries are doing extremely well. Without a deep understanding of the manager's investment philosophy and approach, poor decisions could be made during times when this manager underperforms the broad market indices.

"The most important question in markets is always, what is discounted? What does the market expect, as reflected in prices, and how do my expectations differ?" William Miller



The chart above displays the difference between the annual returns of Bill Miller’s fund and the S&P 500. The fund’s relative results were strong in the early 1980’s, then saw four years of under-performance within a five-year period. It then began a 15-year out-performance streak which will likely end in 2006. In spite of all these relative ups and downs, one dollar invested in the fund in 1982 would have grown to \$39.5 (for a 15.8% annualized return before taxes) vs. \$24.9 (13.7% per year) in the S&P 500 Index. This is certainly a very impressive record over the life of the fund.

While the discussion of Mr. Miller’s performance streak is interesting, it really isn’t all that relevant for an investor with a longer-term focus. Bill Miller himself has called the streak an accident of the calendar. According to Investors Business Daily, since the streak began in 1991, the fund has trailed the benchmark in 49 out of 180 rolling 12-month periods. It just happened that none of those 12-month periods happened to coincide with the calendar year. When evaluating a manager a review of rolling period returns is a good way to examine a manager’s track record. Since investors don’t just invest in January and sell in December, rolling period returns are useful for examining the investment results earned by investors (who tend to invest money throughout the year).

In a 2003 analysis of their clients, Cambridge Associates, an investment consulting firm to foundations, endowments, and other large institutions, found that 92 institutions in the period from 1996 to 2001 indicated that the decision to switch asset managers, often on the basis of short-term criteria, usually resulted in the destruction of value. This analysis found that the fired equity managers outperformed the managers that replaced them in 58% of the switches over the following year and in 60% of the switches over the next three years. In another study of mutual funds with superior long-term records (i.e., those funds that beat their respective benchmarks by at least one percentage point a year on average over a 10-year period), by Litman/Gregory Analytics, showed that virtually every one of the funds suffered significant relative losses at some point during the 10-year period. In fact, more than 90% of them spent at least a three-year stretch of time during which they under-performed their benchmark by two percentage points or more. Thus, it is critical to evaluate a manager’s performance on factors other than just short-term investment performance, or else decisions to switch managers will likely be poorly timed.

“The test of an outfielder's skill comes when he has to go against the fence to make a catch.” Joe DiMaggio

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