

Selecting Investment Sub-Advisors

To reach your investment goals, it's wise to construct a well-diversified, global portfolio. Among the tools that Madison uses to do this are no-load mutual funds managed by experienced, proven sub-advisors. It is now estimated that there are more than 8,000 mutual funds in existence. Without a disciplined process that can be consistently repeated, trying to select the right funds can be daunting.

In this Insight we highlight a portion of the intensive process we follow when searching for mutual funds and their sub-advisors. Listed below are several categories that we study to determine if the sub-advisor is a good fit for you. As we discuss each category we site specific examples from a search we recently performed. We will refer to the fund we selected as "Fund F" as we would like to focus more on the process than the end result.

Experience – Experience is a critical factor in evaluating a sub-advisor. We consider several items: (1) the management team's tenure at their current firm, (2) their tenure within the specific strategy managed and (3) their experience navigating through difficult economic and market environments. "Bruce", Fund F's founder and lead portfolio manager, has more than 25 years of research and investment management experience; the last 12 at the firm he founded. Bruce works with three experienced analysts who focus all of their attention and time on researching businesses. These three professionals have spent the majority of their careers investing money in the same fashion as they do today and have been working together as a team for nearly ten years. One interesting characteristic of Fund F's depth is their use of independent consultants to provide high level, institutionalized knowledge of specific industries. For example, they engaged a former Admiral of the U.S. Navy to help them better understand the defense industry and the ins-and-outs of defense spending in the federal budget.

Strategy – We search for sub-advisors whose investment approach stands out from the crowd. We view Fund F as one of the most unique strategies we have come across because of its very flexible mandate. Most unique in our opinion is their "devil's advocate" approach. While most sub-advisors develop an idea and then look for additional supporting evidence to make the investment, Bruce and his team develop an idea and then spend all of their energy trying to disprove their thesis. If in the worst case scenario the stock still has merit, they move forward with the investment. Fund F also has a very successful track record buying the debt of companies that are often "misunderstood" at very attractive yields. This approach is very different from that taken by many other funds and complements the other sub-advisors in the portfolio nicely.

Diversification – Diversification is another critical factor and we are always looking for ways to enhance it. Bruce assumes that an investor's stake in his fund, no matter the size, is everything he or she has. And his number one mantra is "Don't lose money!" While Bruce and his team invest the portfolio in only their best 20 to 30 ideas, they mitigate concentration risk by holding a cash position that can exceed 20% when they do not see compelling opportunities. This philosophy sets Bruce apart and enhances your portfolio's diversification.

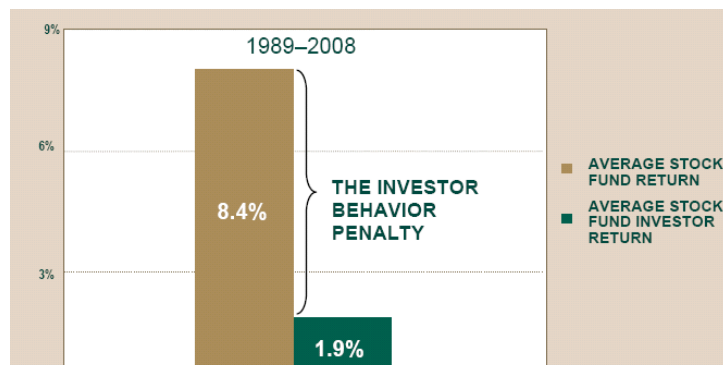
"Much of investing is about not losing, just as much of life is about not dying." Anonymous

Incentives – Human behavior is influenced by incentives. To understand a sub-advisor’s incentives, we study their compensation structure and other motivators. In the case of Fund F, the management team is paid a salary but the vast majority of their compensation comes in the form of bonus pay which directly relates to their fund’s performance. In terms of other motivators, we are always interested in knowing how much of the firm’s officers, directors, and employee’s money is invested alongside their clients in the fund. As of the end of the second quarter, Bruce and his team had more than \$100 million invested in the fund. We view this as the strongest way to align their interest with yours.

Tax Efficiency – The majority of our clients have at least part of their investment portfolio held in a taxable account. Therefore we examine the sub-advisor’s attention (or lack there of) to managing their fund in a tax-efficient manner. We try to understand how much trading the firm does and whether they actively harvest losses to offset realized gains in order to minimize or offset a capital gain distribution. The degree of tax efficiency also influences whether to hold the mutual fund in a taxable or tax-deferred account. We refer to this as “asset location.” Fund F strives to maximize after-tax returns. On average, Bruce has held investments for more than five years which reduces the likelihood of paying short-term capital gains which currently are taxed at higher rates than long-term gains for most individuals.

Costs – We consider a mutual fund’s expenses in relation to its long-term investment returns. Fund F charges a 1.0% management fee for their services – in our opinion a very fair and reasonable cost to have Bruce and his talented team working on your behalf. When available, we take advantage of mutual funds that offer an institutional share class, which lessens the ongoing expenses of the fund. As always, we do not invest in mutual funds or any other financial products that carry a sales charge or “load”.

Long-Term Performance – Far too often performance is the only factor evaluated when deciding whether to buy or sell a mutual fund. By chasing performance, the average investor in stock mutual funds has underperformed the underlying fund itself by 6.5% per year over the past 20 years. Fund F has delivered very strong relative and absolute performance during its lifetime. Over the last ten years Fund F has earned 12% per year, versus -2% for the S&P 500 Index over the same time period. Despite their success we fully expect this fund and all the others we invest in to hit an occasional rough patch along the way. Recognizing the inevitability of short-term underperformance keeps us focused on the long-term.



Source: Quantitative Analysis of Investment Behavior by Dalbar and Lipper

The most difficult and often overlooked item to judge is culture, yet we have seen time and again how a successful firm can be destroyed by a poor corporate culture. For this reason, we make periodic trips across the country to the offices of our sub-advisors. It is in this normal day-to-day setting on their turf where we learn so much about a firm’s culture. Recently we traveled to meet Bruce’s team in Florida.

The process of reviewing our sub-advisors is ongoing. We closely track the mutual funds that we invest in or that we are considering for a future investment. We read their written updates, participate in conference calls, and try to meet with them in their office and ours. We believe your commitment to invest for the future coupled with our goal-based financial planning and disciplined investment process will help you reach your goals and live your dreams!

"Nothing is more harmful to the service, than the neglect of discipline; for that discipline, more than numbers, gives one army superiority over another."

George Washington