

First Quarter 2007 Knowledge College

Further Analysis of Manager Performance, Consistency and Persistency

Our recent paper, “The Next Chapter in the Active versus Passive Debate” examined the performance of almost 1,600 mutual funds with ten-year records across 17 categories. We’ve summarized the key findings from that paper below.

Key Observations

- ▶ Approximately **90 percent of ten-year top quartile mutual funds across 17 categories spent at least one three-year stretch in the bottom half of their peer groups.** It may have been difficult for many investors to hold these long-term top performers through their inevitable lulls.
- ▶ The greater an asset class’ absolute return during a 3-year period, the greater the likelihood and magnitude of median manager underperformance and vice-versa. In other words, **indexes usually performed better than median managers in bull markets and worse in bear markets on a relative basis.**
- ▶ **Holding the 48th percentile mutual fund across 17 categories would have matched the weighted-average index return for a globally diversified 70 percent equity and 30 percent fixed income hypothetical portfolio mix** over the last ten years. Investing with top quartile managers would have led to about 1.0 percent of annual outperformance at the aggregate portfolio level. Bottom quartile managers would have generated -1.3 percent of alpha.
- ▶ There are **frequently ignored factors that can preclude passively managed portfolios from matching index returns.** The factors vary depending on the asset class and index, but are important to consider before making the active or passive management decision.
- ▶ **Falling prey to natural human behavioral tendencies during the manager selection and termination process generally leads to failure.** Investors should make better efforts to understand their managers’ investment processes, sub-styles and investment philosophies in order to develop the patience required for long-term success; or they should invest passively.



Ten-year top quartile funds (ending December 31, 2006) that fell below median during one or more three and five year periods

Category ¹	Funds with 10-year records	10-year top quartile funds	Number of 10-year top quartile funds below median for a 3-year period	Percent of 10-year top quartile funds below median for a 3-year period	Median years spent in bottom half during next rolling 3-years	Percent of 10-year top quartile funds below median for a 5-year period
Intermediate Bond ³	182	46	34	74%	0.5	38%
High Yield Bond	63	16	15	94%	1.0	50%
Foreign Bond	20	5	4	80%	2.5	60%
Large Cap Value	171	43	41	95%	0.75	40%
Large Cap Blend	270	67	61	91%	1.25	41%
Large Cap Growth	217	54	48	89%	1.25	46%
Mid Cap Value	32	8	6	75%	1.0	25%
Mid Cap Blend	70	18	17	94%	1.5	72%
Mid Cap Growth	119	30	29	97%	1.25	53%
Small Cap Value	42	11	11	100%	1.0	64%
Small Cap Blend	68	17	17	100%	1.25	41%
Small Cap Growth	115	29	27	93%	1.25	48%
REIT	27	7	6	86%	2.0	71%
Foreign Value	35	9	9	100%	1.0	56%
Foreign Blend	90	23	19	83%	1.0	35%
Foreign Growth	37	9	6	67%	0.75	56%
Emerging Markets	38	10	9	90%	1.0	70%
Total:	1596	402	359	89%	1.2	51%

¹Distinct Portfolio Only: Many fund families offer multiple versions of the same fund, but with variations on the sales fees that are charged and/or investor qualifications. The "distinct portfolio only" feature removes all but one of these options. Morningstar normally designates the oldest share class as the distinct portfolio, which is often, but not always the A share class.

²The Morningstar mutual fund data was used because it is less prone to some reporting biases than other databases. For example, poor performing managers frequently stop reporting to manager databases during poor performance stretches. While the Morningstar data is not immune to survivorship bias, each mutual fund that survived the ten-year stretch was captured regardless of performance. In addition, the Morningstar data generates returns net of expenses. Many other databases show returns gross of fees. Since fees for institutional investors are often tiered based on asset size, and trading costs are not uniform, it is problematic to calculate objective after-expense returns.

³Four of the twelve top quartile intermediate bond funds that avoided a below median 3-year stretch had the same manager. One of the twelve was an index fund.

Summary

Before any investment endeavor, investors should decide to be either *patient* with their active managers, or consider seeking a *passively managed approach*. As illustrated, the vast majority of long-term top performing managers will endure periods of underperformance. A combination of short-term greed and impatience is a perilous mix that invariably leads investors to fail.

In relatively efficient market segments, where index returns are easily replicable on a cost-effective basis and manager persistency is particularly poor, investors should consider passive management. On the other hand, **where indexing is costly or the index is difficult to replicate, low-cost active management may be the preferred route.**

For more information on "The Next Chapter in the Active versus Passive Debate" and other topics, please visit our Research Center at www.dimeoschneider.com or contact us at (312) 853-1000