# QuarterNotes

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## Researching Funds and Managers, How We Do It?

### In this Issue



**War Worries A Weakened Economy Market Prewar Rally Fades**

*Both the Dow and S&P 500 dropped 4% for the quarter. Only NASDAQ 100 eked out a .4 % gain. After falling in January and February, the mid-March prewar rally added nearly 800 points to the Dow in the best performance for a week in years, showing investors that the market can turn on a dime and those on the sidelines can get left behind.*

*As investors began to realize that the war could last longer and be more costly than anticipated, sellers once again took money off the table.*

*The reality is that markets will probably recover well before all the risks have been removed from our psyches. That's what makes market timing so difficult to correctly predict and why we continue to advocate a balanced portfolio approach.*


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When markets have been ugly, as they have been for the last few years, clients get anxious. Clients have asked, why did the investments you chose lose money? How do you do what you do? So we wanted share some insight into the processes we use in choosing investments.

Past performance only takes us so far in the due diligence process of fund selection. The problem is that past performance is of little use in identifying who will be hot this year. Studies have failed to uncover a strong link between past performance and short-term future performance. So why do investors insist on basing important decisions on data that does not increase their chances for success?

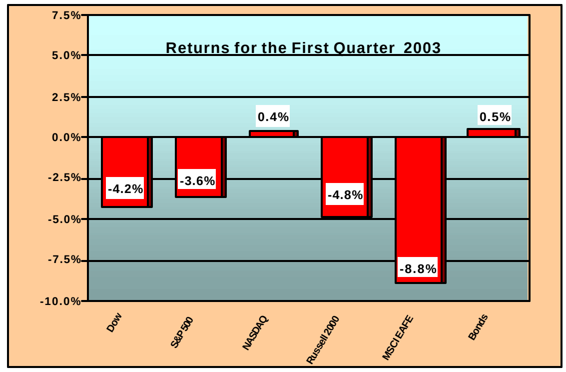
There are several reasons:

1. Many investors either doesn't realize that short-term track records lack predictive value or simply don't want to believe it.

2. The industry, including fund companies, mutual fund rating agencies (with their ranking systems based on recent past performance), the financial media and many advisors all tout past performance, and in doing so, support the fantasy that it can be used as the basis for making successful investment decisions.

3. Investors don't know what else to look for. Numbers are easy to get and easy to understand. Research that goes beyond numbers is labor-intensive and demands experience and knowledge of what to look for, and requires access to fund management firms that most investors don't have.

So why aren't track records predictive? Shouldn't we expect some of the best performing managers to be among the most skilled and therefore, shouldn't funds with better historical records continue to outperform? Our experience evaluating active managers leaves us less than surprised by the inability of winners to consistently repeat. Maintaining a competitive edge is difficult.




Success leads to asset growth and that, especially for small cap managers, reduces maneuverability resulting in a smaller universe of investable stocks. Success creates stardom for managers tempting fund companies to launch new products for their "star managers". This distracts them, reducing their focus on the original fund. Focus is critically important to winning the investment game.

Star status also fosters turnover. Successful managers may be lured to other firms or strike out on their own. If managers become spread too thin they often expand their team. While this may add depth, it can also be negative if responsibility is delegated to less skilled or untested team members. Success can lead to overconfidence which can result in sloppiness or the downplaying of the risks that result from the success traps discussed above.

### Why Not Just Index?

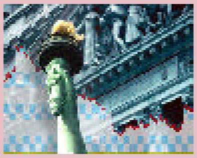
The fact that track records are not useful in predicting future relative performance is the basis on which index fund proponents conclude that low cost index funds are the better choice. The argument is persuasive. However, we believe that the fact that track records are not predictive does not mean that superior future performers can't be identified, especially in certain market climates; for example when world economies are not growing rapidly and markets are expected to be relatively static. It simply means that the track record does not provide sufficient information to do so. (Does anyone really expect that investment success should be as simple as projecting the past into the future?)

**Economic Outlook**

*The economy has recently lost some of its momentum. Uncertainty and fear caused by the War along with rising oil prices are weighing on activity. It has been difficult to discern how much of the weakness is due to geopolitical events and how much is attributable to real economic causes.*

*The near term outlook hinges on how the War and other international issues unfold.*

*If the War is not prolonged and oil prices recede, then we are likely to see a recovery begin slowly and continue throughout the year.*



**Statement Bundling**

*Schwab is now able to "household" the mailing of monthly statements to the same address with the same tax ID. You can further reduce your mailings, by signing a form to have all statements to the same address mailed in a single package. Call us to obtain this form.*

Our approach to fund research recognizes that past performance is useful only as a tool for screening funds to identify those that may be worthy of further research. Value added comes from identifying why a fund performed well, determining if the portfolio management team has an identifiable edge and assessing whether the edge is sustainable.

### The Fund Research Process

**Step One:** Quantative screens are the starting point in our research process. We consider funds that have outperformed their peer group and benchmarks over a reasonably long period of time. Generally we require a minimum of five years of performance. Occasionally we will consider funds with a shorter record, notably if we can identify a manager's prior track record or a separate account record prior to the fund's inception.

In addition to absolute performance we evaluate:

- ☑ Performance consistency relative to its peer group and benchmark.
- ☑ Special factors that impacted performance that may not be repeatable.
- ☑ Asset size on which the record was based.
- ☑ Expenses; lower is better.
- ☑ Availability of institutional class shares .

**Step Two:** Review independent research which we purchase from several different sources. Evaluate both quantitative and qualitative information about performance, the process, the depth and breadth of the team, buy and sell disciplines, diversification vs. concentration mandates and tax efficiency.

**Step Three:** Discussions with fund management to get a feel for their commitment to their style, discipline, etc. and to establish a contact which serves as a source for updates and insight on a timely basis. In difficult markets we want to know what is working for them as well as what has failed them and the reasons why.

**Step Four:** We synthesize this into our own due diligence summary which briefly describes the following:

1. Fund Overview
2. Process
3. Role in Client's Portfolio
4. Our Analysis
5. Current Recommendation

**Step Five:** We continually monitor and update our reviews and process because going through all the above steps does not guarantee success. What it does give us is confidence that we have chosen a highly

*(Continued next column)*

disciplined and focused team which will serve the long-term interests of our clients.

Our process allows us to be patient with managers who go through a slump, as they all do eventually. Because our recommendations are based on substantive research, we have the confidence to ride through a slump as long as something material has not occurred that causes us to reassess the decisions that led to the initial recommendation.

Investors want quick answers, but their goals are long-term. We must attempt to match the investment policy to both the time horizon and the clients' stated goals.

### Why doesn't this always work?

We strive to choose managers who will deliver superior performance all the time, but realistically this is impossible. There are periods when superior managers will underperform. We have just experienced a time where managers' performance have not lived up to our expectation or theirs.

Temporary periods of underperformance especially for focused portfolios are not unique and they are frequently followed by periods of outperformance. We have observed that periods of lagging performance often coincides with instances where the stock markets are emotionally charged, driven not by fundamentals, but by either fear or greed. There have been an unusually large number of these periods in the last few years. Fortunately, except for 2002, those periods seemed to be short lived and many of our funds even though underperforming in 2002 have still outperformed their benchmarks and peer groups for an extended period of time.

Since our expectation of fund managers is to focus on delivering long-term performance, they tend to be at a disadvantage when markets do not focus on long-term fundamentals. Factors that cause diversified portfolios using active managers to work out well for the long run, sometimes handicap them in the short run.

While there is never any guarantee that the past performance experience will repeat itself, we have observed the patterns and are not alarmed about short periods of temporary underperformance. We believe we have done our due diligence well and we have confidence in our managers.

We would love every period to be superior, but know that isn't realistic. What we do expect is good long-term performance and relatively strong consistency.