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Kind Regards,



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## Three Strikes, You're Out: Approaches Used to Manage Actively Managed Portfolios

**Overview:** This article looks at three active management approaches investors often use to try to pick winning stocks or actively time the market. Investors try to: 1) actively pick securities on their own, 2) pick mutual funds that are actively managed by fund managers or 3) hire someone to select active managers for them. The evidence included in this article shows us that none of these approaches are expected to work as effectively as a passively managed strategy for achieving long-term financial goals. Together, we feel they form a "three strikes and you're out" approach to investing. The strategy we advise is to build a globally diversified portfolio of passively managed asset class investments; periodically rebalance the portfolio to remain adherent to a carefully formed, disciplined investment policy; and otherwise "stay the course" regardless of market events.

### Introduction

One theory about how markets work claims that there are smart people who can uncover securities that somehow have been mispriced by the market. In the case of equities, that means that there are people who can identify which stocks are under- or overvalued. This is called stock picking or stock selection. In addition, the theory maintains, clever individuals can identify when the bear is about to emerge from hibernation (it's time to get out of the market) and when the bull is about to start another rampage (it's time to jump in and get fully invested). This is called market timing. Together, stock picking and market timing form what is known as active management.

Individuals who believe that active management will produce the best results can personally select their own stocks, select actively managed mutual funds or hire someone to perform the task of active management for them.

Unfortunately, whether an investor is flying solo or working with an “expert,” evidence is overwhelming that he or she is unlikely to outperform proper benchmarks, particularly after the costs involved in the effort. As the following examples demonstrate, even hiring professionals to perform the role of due diligence and selection is unlikely to produce benchmark-beating results. Let’s take a look at the evidence on each of the three strategies. We begin with how do-it-yourself investors have fared.

### **Strike One! Individual Investors Don’t Make the Grade When They Trade**

Overconfidence can be a healthy attribute, creating a positive framework in which to get through many facets of life. Unfortunately, investors who are overconfident of their investment skills generally experience poor investment results. Let’s look at some evidence to support this statement.

University of California professors Brad Barber and Terrance Odean have produced a series of landmark studies on the performance of individual investors. They have concluded that individual investors aren’t as bad at stock picking as many people think — they’re worse. The following is a summary of conclusions from past studies they have authored or co-authored:

One study found that stocks purchased by individual investors *trail* the overall market and that stocks they sell *beat* the market after the sale. Those results did not include investors’ transaction fees and taxes. The study concluded that individuals shouldn’t have tried to pick stocks. The time and money they spent cut into their profits instead of enhancing them.<sup>1</sup>

Another study on the frequency of trading by individuals found an inverse correlation between confidence and performance — the more confident an investor was in his or her ability to trade, the worse the results turned out to be.<sup>2</sup>

When a study compared the investment returns of men versus women, it found, although the stock selections of women did not outperform those that the men selected, women produced higher net returns because they traded less often. Their lower turnover produced lower trading costs. The study concluded that a common characteristic of human behavior is that, on average, men exhibit more confidence in skills they don’t have.<sup>3</sup>

### **Strike Two! Actively Managed Mutual Funds Struggle to Outperform Their Benchmarks**

Individuals also try to beat the market by selecting mutual funds that they believe will outperform their benchmarks. Let’s look at the evidence on the returns of mutual funds, as well as the returns of individuals who invest in mutual funds. There is a difference.

A study published in the Summer 2000 *Journal of Portfolio Management* found that, for the 10-year period 1982–1991, only about 8 percent of actively managed funds beat their

benchmark on an after-tax basis.<sup>4</sup> While the average outperformance was just 0.9 percent, the average underperformance was 3.1 percent. And this, in an environment in which there were about 11 times as many losers as winners.

The same study found similar results for the 10-year period 1989–1998. On an after-tax basis, only 9 percent of the funds outperformed. The average outperformance was just 1.8 percent while the average underperformance was 4.8 percent.

Actual odds investors faced were likely even worse, because the above data contains survivorship bias. That is, funds that performed poorly closed because of redemptions by investors or they were merged out of existence by their sponsor. That means it is likely that the worst performing funds during these periods were not included in the data.

### **Morningstar Study Finds Investors Did Not Benefit From Using Market Timing Strategy**

Another study worth noting is the Morningstar study that evaluated 199 mutual funds for which they had performance data for the period 1989–1994. “The average total return for the 199 funds over this six-year period was 12.01 percent.”<sup>5</sup> The individual owners of those same funds (keeping in mind that the average no-load mutual-fund investor holds his or her funds for only 21 months) for their various periods of ownership received a return, however, of just 2.0 percent. Either market timing or chasing the hot manager turned their potential 12.0 percent returns into 2.0 percent.

Even without taking into account the investment behavior of investors, mutual funds provided a very slim chance of outperformance. When we adjust the returns of the funds to take into account investor behavior (underperforming the very funds they invest in by 10 percent per annum), it appears that investors were taking all the risks of stocks, but earning only a very tiny percentage of the returns.

### **Investors Have Not Benefited From Using Morningstar Ratings**

One approach that some investors use to select mutual funds is to rely on the information provided by Morningstar, which rates funds using a star system similar to the one used by film critics. Morningstar gives the coveted five-star rating to the funds it believes are among the top 10 percent, and a one-star rating to the bottom 10 percent. *The Hulbert Financial Digest* tracked the performance of five-star funds for the period 1993–2000. For that eight-year period, the total pretax return on Morningstar’s top-rated U.S. funds averaged 106 percent. This compared to a total return of 222 percent for the market, as measured by the Wilshire 5000 Equity Index. The study also found that the top-rated funds, while achieving less than 50 percent of the market’s return, carried a 26 percent greater relative risk (as measured by standard deviation).<sup>6</sup>

Another study by *The Hulbert Financial Digest* looked at a portfolio of 55 funds that Morningstar rated highest for the period January 1991–March 2002.<sup>7</sup> This portfolio, which bought funds when they climbed into this elite group and sold funds when they dropped out of the five-star rating group, trailed the market by 6 percent per annum after paying sales

charges, redemption fees and other transaction costs. Finally, a study by Morningstar found that one-star funds outperformed five-star funds by 45 percent for the period 1995–2001.<sup>8</sup>

### Strike Three! Using a Manager of Managers

The third way that individuals try to actively beat the market is to hire someone to help them select outperforming money managers. Let's look at some evidence on that strategy.

There are investment advisory firms that are managers of managers. Typically, these firms search historical databases to identify the best performing funds or separate account money managers for each asset class. Then, through a rigorous due diligence process that includes interviewing the various candidates and eliminating those who fail to pass strict selection criteria, they narrow their choices down to the best managers before making their final selections. The process might seem logical but the question remains: Can they be expected to outperform?

SEI is one of the largest firms in this arena. As of the period ending March 31, 2005, SEI was administering more than \$291 billion in mutual fund and pooled assets, and managing more than \$123 billion in assets. Given its leadership role, SEI should serve as a good test case by comparing the returns of its funds to those of the passive asset class funds managed by Dimensional Fund Advisors (DFA).

### Notes about the Fund Comparison in Table I

We compared one-year, three-year and five-year returns for the period January 2000–December 2004, which covered a full market cycle — beginning with a bear market (2000–2002) and ending with a bull market (2003–2004). In the case of international funds, SEI had only one international large-cap fund and one emerging markets fund. DFA offered funds in additional asset classes, allowing for broader, more effective diversification. The figures in shaded cells note a period in which the DFA fund underperformed the comparable SEI fund.

| Fund                                   | 2000       | 2001        | 2002        | 2003 | 2004 | 2002–2004 | 2000–2004 |
|--|------------|-------------|-------------|------|------|-----------|-----------|
| SEI Large-Cap Growth (SELGX)           | -19.4      | -26.5       | -29.2       | 25.3 | 7.6  | -1.6      | -10.8     |
| DFA U.S. Large Company (DFLCX)         | -9.3       | -12.1       | -22.2       | 28.5 | 10.7 | 3.4       | -2.5      |
| SEI Small-Cap Growth (SSCGX)           | -12.4      | -12.5       | -33.7       | 56.0 | 9.6  | 4.2       | -2.8      |
| DFA Micro-Cap (DFSCX)                  | -3.6       | 22.8        | -13.3       | 60.7 | 18.4 | 18.2      | 14.3      |
| SEI Large-Cap Value (TRMVX)            | 5.7        | -3.5        | -17.8       | 29.5 | 15.1 | 7.0       | 4.6       |
| DFA Large-Cap Value (DFLVX)            | 10.2       | 3.9         | -14.9       | 34.4 | 18.3 | 10.6      | 9.1       |
| SEI Small-Cap Value (SESVX)            | 23.1       | 12.4        | -11.6       | 42.8 | 23.0 | 15.8      | 16.5      |
| DFA Small-Cap Value (DFSVX)            | <b>9.0</b> | 22.6        | -9.3        | 59.4 | 25.4 | 21.9      | 19.4      |
| SEI Emerging Markets (SIEMX)           | -34.5      | -2.5        | -8.0        | 49.1 | 25.2 | 19.7      | 1.9       |
| DFA Emerging Markets (DFEMX)           | -29.2      | <b>-6.8</b> | <b>-9.4</b> | 60.2 | 29.9 | 23.5      | 4.5       |
| DFA Emerging Markets Value (DFEVX)     | -34.2      | -1.0        | -1.7        | 76.2 | 39.5 | 34.2      | 9.5       |
| DFA Emerging Markets Small-Cap (DEMSX) | -31.8      | <b>-2.6</b> | -0.2        | 72.8 | 28.9 | 30.5      | 8.1       |

|                                   |       |       |       |      |      |      |      |
|-----------------------------------|-------|-------|-------|------|------|------|------|
| SEI Int'l (SEITX)                 | -17.7 | -22.6 | -17.0 | 31.9 | 18.7 | 9.1  | -3.7 |
| DFA Int'l Large-Cap (DFALX)       | -14.0 | -20.8 | -14.6 | 36.7 | 18.8 | 11.5 | -1.1 |
| DFA Int'l Large-Cap Value (DFIVX) | -0.2  | -15.3 | -8.5  | 49.9 | 28.8 | 20.9 | 8.4  |
| DFA Int'l Small-Cap (DFISX)       | -5.4  | -10.5 | 1.9   | 58.8 | 30.9 | 28.4 | 12.4 |
| DFA Int'l Small-Cap Value (DISVX) | -3.1  | -4.6  | 5.8   | 66.5 | 34.8 | 33.4 | 17.0 |

Source: Dimensional Fund Advisors Returns®

Note: The performance data shown represents a one-year, three-year and five-year comparison of returns. These time periods were selected to provide a comparison based entirely on live data.

### Table I Discussion

For the five-year period, there was no asset class in which SEI funds outperformed DFA. The underperformance ranged from 2.9 percent per annum to 17.1 percent per annum, and averaged 8.5 percent per annum.

For the 55 individual year data points, the DFA funds underperformed the SEI funds only four times, or less than 8 percent of the time.

Also noteworthy — the SEI funds were far costlier. The expense ratios of the six SEI funds ranged from 0.85 percent to 1.95 percent, averaging 1.19 percent while the 11 DFA funds had expense ratios ranging from 0.15 percent to 1.04 percent. If we take the average expense ratio for the DFA funds in the six broad asset classes listed above (to get an apples-to-apples comparison), the average expense ratio for the DFA funds would be just 0.46 percent, or 61 percent less expensive.

Given the significant resources at SEI's disposal, the above results provide a powerful example of the failure of active management to provide superior returns as compensation to investors for accepting the risk of underperformance. Do-it-yourself investors, as well as individuals using stockbrokers or financial planners to help them choose money managers, should ask themselves what skills, resources, or other advantages they (or those that they hire) have that will allow them to succeed where firms like SEI have failed. If investors are unable to identify an advantage, they should conclude that the expected results will likely be similar.

### Conclusion

With so many studies demonstrating that individual investors and professional money managers alike struggle to achieve market returns, we would suggest that the financial markets are functioning as expected according to the academic wisdom on the subject. Prices for public securities are fair (they are the best estimate of the correct price). Adam Smith's "invisible hand" works. The result is that, with everyone competing with each other, even highly informed people cannot reliably take advantage of the uninformed to earn excess profits. It seems that the wisdom of the crowd is a very tough competitor indeed. The distinction between public markets and other areas of endeavor where hard work is rewarded cannot be overemphasized.

For some investors, active investing is exciting. However, investing was never meant to be exciting. Instead, it should be about providing investors with the greatest odds of achieving their financial goals with the least amount of risk. For many investors, their primary objective is to achieve long-term goals with their investments — such as saving for their children's college education, retiring comfortably and/or leaving behind a legacy. Building a

passively managed portfolio according to a carefully designed strategy with regular, disciplined rebalancing seems a more prudent way to expect to achieve such goals.

The following words of wisdom from Daniel Kahneman, Professor of Psychology and Public Affairs at Princeton University, serve as a fitting conclusion.

“What’s really quite remarkable in the investment world is that people are playing a game which, in some sense, cannot be played. There are so many people out there in the market; the idea that any single individual without extra information or extra market power can beat the market is extraordinarily unlikely. Yet the market is full of people who think they can do it and full of other people who believe them. This is one of the great mysteries of finance: Why do people believe they can do the impossible? And why do other people believe them?”<sup>9</sup>

- <sup>1</sup> Brad M. Barber and Terrance Odean, **Trading is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors**. *Journal of Finance*, April 2000.
- <sup>2</sup> Terrance Odean, **Do Investors Trade Too Much?** *American Economic Review*, December 1999.
- <sup>3</sup> Brad M. Barber and Terrance Odean, **Boys Will Be Boys: Gender, Overconfidence and Common Stock Investment**. *Quarterly Journal of Economics*, February 2001.
- <sup>4</sup> Robert D. Arnott, Andrew L. Berkin and Jia Ye, **How Well Have Taxable Investors Been Served in the 1980s and 1990s?** *Journal of Portfolio Management*, Summer 2000.
- <sup>5</sup> John F. Merrill, **Beyond Stocks**. Tanglewood Publishing, 1997.
- <sup>6</sup> John Bogle, **The Stock Market Universe — Stars, Comets and the Sun**. Remarks before the Financial Analysts of Philadelphia, February 15, 2001. Available at [http://www.vanguard.com/bogle\\_site/february152001.html](http://www.vanguard.com/bogle_site/february152001.html). Accessed May 31, 2001.
- <sup>7</sup> Mark Hulbert, **A Realignment of the Stars in the Mutual Fund Sky**. *New York Times*, May 19, 2002.
- <sup>8</sup> David Rynecki and Ellen Florian, **Stargazers, Beware: Morningstar Has Realigned the Galaxy of Mutual Funds**. *Fortune*, July 8, 2002.
- <sup>9</sup> **Hard Wired**. *Dow Jones Asset Management*, November/December 1998.

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