February 4, 2014

Ten-Year History of Investment Manager Performance

Dear Clients & Friends of Falcons Rock:

This past September, our firm celebrated ten years of assisting institutional and family clients with their investment portfolios. Falcons Rock offers a wide variety of investment consulting services, which broadly include:

- Analysis of Current Investment Position
- Design of Optimal Portfolio
- Formalize Investment Policy
- Implementation of Investment Program
- Ongoing Supervision

As part of our process, we have conducted investment manager research and due diligence resulting in manager or fund recommendations to our clients. Our research is based on client-specific objectives, statistical analysis and interviews with investment managers. I thought it would be interesting to go back to our early recommendations, made during our first year in business, and measure the results of these investment managers. Among our earliest clients, we made recommendations of 29 different investment managers/products. Of these 29 products, one mutual fund was acquired and two funds closed, leaving 26 products for which we measured performance for the ten-year period ending December 31, 2013. Here are our findings:

- 73% of these products generated returns in excess of their benchmark index.
- 92% of these products' returns ranked in the top half of their respective peer groups.
- 50% of these products' returns ranked in the top quartile of their respective peer groups.
- 58% of these products' returns plot in the Northwest quadrant (higher return, less risk) of a risk/return scatterplot, relative to their respective peer groups.
- 69% of these products' downside capture ratio ranked in the top half of their peer group.
- Of the 7 products that underperformed relative to their index, the average underperformance was -0.56% (annualized).
- Of the 19 products that beat their index, the average annual outperformance was +1.06%.

Throughout this turbulent ten-year period, each of these products has experienced periods (sometimes as long as 3-5 years) during which their performance trailed an index or fell in the bottom half of a peer group. Investor patience is required during such periods when a manager's investment style may fall out of favor, or rampant market speculation may drive an index to extreme heights. In a previous article, I described research we conducted that suggests active management outperforms indexing during bear markets, but often underperforms during soaring bull markets.

We are typically slow to recommend changes of investment products, and we almost never recommend an investment manager change solely due to performance issues. In our experience, good investment managers that stay true to their style will prevail over longer time frames and through multiple market cycles. We believe that, if we can do a good job of identifying quality managers for our client situations and feel comfortable with our due diligence efforts up front, there should rarely be a need to suggest a change.

That being said, there are situations for which a manager change may be necessary. For example, if a client's objectives change, there may no longer be a need for a manager of a certain style. If a lead portfolio manager suddenly leaves the firm, caution may be warranted unless the management team is deep and experienced. If the manager alters his or her investment process, a red flag is raised and we subject that manager to a deeper level of scrutiny. If an investment management firm is acquired by another firm, we closely monitor the situation to determine if the new parent firm begins to make personnel or process changes. While investors tend to focus solely on returns and may be quick to replace funds that underperform over short intervals, it is often these softer issues that are more indicative of future results.

Our approach is not commonly applied among investors or even other investment consulting or advisory firms. Large advisory firms, which may employ dozens of investment manager analysts, often fall victim to the "returns trap" and recommend manager changes at inopportune times. These firms and advisors know that it is easier to sell their clients on the idea of replacing managers that have underperformed than it is to explain reasons to keep these managers. Many Investment Policy Statements are written with a mandate to replace managers due to underperforming a benchmark index over a relatively short time frame. This approach often makes their clients feel better and seem smarter, but may not improve the client's portfolio results going forward. Many good managers that fall in the bottom half of a peer group in recent periods often rise to the top of their peer group in future periods. If that manager was replaced at the bottom of their cycle, investors will not capture the better future return. While our firm is relatively small, we believe that our recommendations are based on sound fundamental analysis and the knowledge we've gained through our experience in monitoring investment managers.

The popular press often espouses indexing as the best way to invest. Index funds clearly have a cost advantage over most actively managed funds and that is attractive. Any portfolio, whether using indexing or active management, should pay close attention to investment fees. High fee products have a big hurdle to cross, and studies have shown that high fees are detrimental to long-term results. We screen all investment products for fee structures and generally search for products with expenses in the lower half of their respective peer groups. For investors who do not have experience analyzing actively managed funds, indexing can work very well. We believe our ten year manager performance history demonstrates that our experienced and patient approach can help identify active managers that have a good chance of outperforming their index and peer group.

Whether indexing or not, it is investor behavior that drives the ultimate portfolio return. When things are not going well, investors often feel a need to "do something" thinking that taking action will improve the results of their portfolio. Only skilled investors or seasoned investment professionals typically realize better returns as a result of such behavior.

I founded Falcons Rock on the premise of providing sound investment counsel and a "straight talk" approach to serving our clients. Ten years later, I still believe that our approach is in the best interest of our clients and the results seem to confirm this belief.

We sincerely thank our earliest clients who have stuck with us through a challenging, but rewarding, ten year period.

Greg Wait

President, Falcons Rock Investment Counsel