

# *The Search for Exceptional Mutual Fund Managers*

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*If we want to find equity mutual funds that will provide us with excellent investment returns over the next several years, wouldn't it be logical to select from funds that have had excellent returns the past several years? Unfortunately not. The observed correlation between past and future performance of equity mutual funds is very weak. I firmly believe that exceptional managers exist, and that they can persist in delivering above average relative performance over the long haul (even if not every year). But there is much more to identifying them than simply looking at their past performance or Morningstar star ratings. This article discusses how we should go about searching for exceptional managers and specifically how I am able to do this here at Marshalla Asset Management.*

## ***Does the Past Predict the Future?***

By and large, both investors and fund professionals rely heavily on past performance in their fund selection process. *The problem is that past performance is of little use in identifying funds or managers who will deliver superior future performance relative to their peer group.* Many studies have failed to unearth a significant positive correlation between past relative performance and future relative performance. The only clear correlation found has been the consistency of managers with very bad returns to continue to post bad returns in the future.

**Long Term vs. Short Term** - Some fund companies and investment commentators advocate that while investors are wise to ignore short term track records, they *should* rely on longer term records for selecting funds and managers. Unfortunately, those who have researched the matter carefully have found just the opposite: long term performance history tells us even less about future manager performance than short term performance history.

This finding is hard to swallow at first. But it is based on numerous independent studies, a nice compilation

of which can be found in a recent article in the Journal of Financial Planning<sup>1</sup>. This comprehensive survey article summarizes the results of every study published on the subject since 1990 in the three most highly ranked academic finance journals, plus some others. These studies generally do find some short term momentum in manager performance (much as we find in the stock market), but it tends to dissipate after a year or so. If you are selecting your mutual funds strictly by looking at five year performance records, you may as well pick them by throwing darts.

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*If past performance cannot point us to superior equity fund managers, what can? Do they even exist? And if so, how can we find them?*

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**Morningstar Stars** - So what about the famous Morningstar star ratings? This mutual fund ranking system must be by far the most widely referenced system by investment websites, publications and the funds themselves. Is it a waste of time to select funds based on Morningstar stars? My answer would be yes,

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<sup>1</sup> "Hot Hands, Cold Hands: Does Past Performance Predict Future Returns?" by William G. Droms, Journal of Financial Planning, May, 2006; p. 60 – 69 – available to MAM clients on request

if that is all an investor relies upon, and Morningstar itself would agree. However, the Morningstar star ratings system *may* now have some *modest* value in the fund selection and monitoring processes, especially since it was seriously re-vamped in 2002.

The Morningstar star rating is a quantitative metric based strictly on past fund performance, combining a fund's weighted 1, 3 and 5 year past performance records. The new system is actually too new to draw definitive conclusions, but the initial results do appear to demonstrate some mild correlations between the star ratings and future fund performance.<sup>2</sup> This was definitely not true of the original Morningstar star system, with the exception of the one star rating, which was shown to correlate to poor future performance. The important changes in the new system are two things:

- The returns are risk-adjusted, using a newly devised Morningstar measure of risk.<sup>3</sup>
- The star rankings are computed within the manager's style grouping, rather than within the entire universe of equity fund managers (so, for example, small value managers are compared to other small value managers, rather than all fund managers).

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*The new improved Morningstar star rating system contains some useful information, but it is nowhere near enough to identify the best funds.*

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The results of the first three years of using this system are in the direction hoped for, but the magnitudes are quite modest, and it is not clear if they are statistically significant. Funds rated 5 stars when the new system was initiated were on average rated 3.1 stars three years later. Those rated 4 or 3 stars initially turned into 3.0 and 2.8 star funds, respectively. And those rated 1 or 2 stars, came out rated 2.7 stars three years later. So far so good, but hardly the kind of strong

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<sup>2</sup> "Rating the Star Rating", by Russell Kennel (of Morningstar) published on Morningstar.com 12/5/05 – available to MAM Clients on request

<sup>3</sup> For my decision analyst clients, they actually use a convex utility function to measure risk, rather than simply use the standard deviation of returns. As a result, upward deviations from the mean add less to risk than downward deviations.

evidence that investors should seize upon as a way to select investments.

## ***Why Doesn't Good Performance Persist?***

Why should it be that managers who have built up solid long term performance records are on average little more likely to succeed in the future than managers with just average past performance? This is an open question, and is part of some huge issues in the investment world, which I can only lightly touch upon here.

**Market Efficiency** - A challenging explanation would come from the efficient market advocates: *No one can beat the market consistently, so past performance success is just luck.* I'm sure this is true for many of the managers, but I don't believe this is the complete story, or I would not be pursuing active management. While there is some substance within the argument, the existence of an efficient market is not an all or nothing proposition. The question is not whether the market is efficient or not, but *how* efficient is it? My answer is that it is pretty darn efficient, which is what makes it very hard, but not impossible, to achieve persistent long term success in investing.

Researchers over the past 15 years or so have developed evidence that equity markets are beset both by *systematic* inefficiencies brought about by persistent investor behaviors, as well as temporary, but sometimes dramatic, departures from rationality (bubbles anyone?) brought about by bandwagon and greater fools effects. In these cases investor actions are influenced by the actions of the market itself rather than by the fundamentals of its underlying securities, as would always be the case in a purely efficient market.

**Benchmark Selection** - Another reason that managers may have a difficult time proving persistence of good returns is the selection of benchmarks used to gauge their performance. What does it mean to beat the market, or to beat your peers? Should we compare a manager's performance to the S&P 500, or a broader measure of the market's performance, like the Russell 3000? Or should we use a benchmark that represents a particular style, like small cap growth or large cap value? It has become increasingly popular to measure manager performance against these more narrowly defined style benchmarks. This is perfectly appropriate for some managers who are committed to

investing within stocks included in the given style box. But other managers may define their opportunity sets more broadly, or may have a well defined investment methodology that sometimes picks stocks from one style box, and at other times from another. If the style of stocks selected is part of the investment manager's discretion, then using a specific style box benchmark to gauge her performance is artificial. Deciding what benchmark or peer group to compare a manager's performance to is more complex than most people realize, and it is among the factors that can distort the measured performance of a given manager (for good or bad).

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*Good manager performance usually fails to persist for long because (a) in many cases the initially good performance was only luck, and (b) initial success often "spoils" a fund.*

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**Some Managers Do Get Worse** – Another reason it is hard to find managers who maintain their initially excellent record is that lots of them really do deteriorate as portfolio managers after their initial run of success. There are numerous reasons for the deterioration. Asset bloat is a big one. After a new or small fund demonstrates success, investor assets begin pouring in and continue to such an extent that it becomes impossible for the manager to maintain his original methodology. This is especially true for small cap managers, but it can be applicable to any. When assets under management grow too large, the fund manager may find that if he buys as much of a company's stock as he would like, the trade would adversely impact the market price or even exceed the legal thresholds for percentage of company ownership. To avoid this, they may end up having to buy many more companies than before, thereby diluting their best ideas and their stock picking abilities, and/or move upscale to buy larger companies, and/or allow uninvested cash to accumulate.

Diversion of manager responsibilities is another frequent drawback of success. The manager of an initially successful mutual fund will often be "rewarded" with more marketing responsibilities. After all, his fund is now a hot product, and the company wants him out there selling. Or they may promote her to higher position within the company, increasing the amount of time spent on internal management responsibilities. But the more time the

manager spends marketing or managing within her company, the less time she has to tend to investing.

The drawbacks of success are numerous. Another is overconfidence. The manager becomes lazy or thinks he has the Midas touch, and loses his edge and intensity. Fund analysts grow impatient for recognition, and team dissension and turnover begin to increase. These are all factors that tend to diminish continuation of investing success. They are difficult for the average investor to notice, but there are ways to identify such trends in advance of the problems they may cause.

## ***So Are There Managers Who Can Maintain Exceptional Performance?***

**A Few Good Men (and Women)** - Despite the general lack of predictability of past track records I do believe there are exceptional equity managers for whom above average performance is likely to persist over long periods. So why can't we see this in the aggregate data? The reason is there are so many more managers who are not exceptional that the effect from the tiny number of truly talented managers is simply swamped by the noise of the vast majority who aren't.

Despite the lack of patterns in the aggregate data, there are managers whose good performance has persisted for a decade or longer. For example, Chuck Royce is one of, if not *the*, longest tenured small cap fund managers in the business. He has run the Pennsylvania Mutual fund (a component of many of our portfolios at MAM) since its inception in 1962 (!). This fund is seldom one to come in as one of the year's ten best performers, yet it has easily bested its Russell 2000 benchmark, net of costs, for the last 1, 3, 5, 10 and even 30 year periods (this was as far back as I could ascertain performance).<sup>4</sup>

**Persistency versus Consistency** - It is worth distinguishing between *consistency* and *persistency* of good investment returns. It is important not to let the former distort our search for the latter. We certainly look for consistency of good relative returns when

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<sup>4</sup> Pennsylvania Mutual's compound annualized total return for the 30 years ended June 30, 2006 was 15.6%, versus 14.3% for the Russell 2000. Thus, the fund would generate 40% more wealth over the period than would the costless index (if you could indeed hold a costless index). Note: The Russell 2000 index was initiated in 1979, so I used the returns from Decile 8 stocks for the 2 ½ years before 1979.

searching for an exceptional manager, but we must temper our goals by understanding how much consistency it is reasonable to expect.

We hear a lot of rhetoric about how even great managers will lag their benchmarks and their peers from time to time, and that as investors we should be patient and stay the course with them. But how frequently and to what degree is it reasonable to expect great managers to underperform?

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*Persistence is not the same thing as consistency. Almost all top managers should be expected to experience periods of under-performance as long as three years or more. Persistence of good returns means that waiting out such periods will eventually be rewarded.*

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A study published just last month by a highly reputable source places some factual evidence behind the rhetoric<sup>5</sup>. This study focused on equity funds that had succeeded in beating their benchmarks for the previous ten year period ending with calendar year 2005. The analysis was done separately for each of six domestic fund categories (large blend, large value, large growth, and the similar three categories for small caps). It examined all the rolling three year periods throughout the ten year period to find out how often and to what extent these selected successful managers lagged their benchmarks for three or more years at a time. Remember, this test was applied only to funds that we already know turned out to be superior over a full ten year period. And yet, as the authors say, three straight years of underperformance is “a period that would sorely test the patience of both the manager and the fund’s investors”.

The results are enlightening. They show that between 93% and 100% of the three categories of successful large cap funds underperformed their indices by at least 2% per year for three years or more during the ten year period of overall out-performance. The results were similar for the three classes of small cap funds: 88% to 100% of these “superior” funds suffered underperformance for three or more years running within the decade of overall superior

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<sup>5</sup> “Study of Outperforming Managers Reveals Extent to Which They Underperform Along the Way”, by the Litman/Gregory Company, published online in Advisor Intelligence, September, 2006 – available to MAM Clients on request.

performance. In fact, a good portion of the funds suffered even greater magnitudes of under-performance for three plus years. Just to cite a couple of examples, 72% of the large blend funds and 71% of the small blend funds underperformed their benchmarks by 5% or more for at least three years running. And again, by construction, all of these were the *higher performing* funds over the full ten years.

So it seems pretty clear that once we have found someone we believe is an exceptional manager, we should nevertheless *expect* them to have periods where they underperform their benchmarks and their peers, and be prepared to be patient with them when they do. Not only can we not reliably select managers based on their past performance alone, we should not reject a manager we have selected just because he or she has had a sub par two or three year period. If we did so, we would at one time or another have rejected 100% of all the benchmark exceeding large cap value and small cap value managers in existence over the past ten years!

## ***How Can We Identify Exceptional Managers?***

Since we definitely should not look for or reject equity managers based only on past performance, what criteria *should* we use? The sections below summarize a list of factors I do consider in seeking to identify exceptional managers.

**Operational Issues** – I screen funds based on certain basic operational characteristics before even deciding whether they are worth a closer look:

- Fund operating expenses – A high operating expense ratio (OER) is enough to eliminate a fund regardless of recent performance. Expenses are the one sure thing in investing, and I select funds for MAM portfolios whose expense are well below their category averages<sup>6</sup>.
- Trading turnover – High turnover increases transactions costs and taxes, as well as indicating

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<sup>6</sup> The top fund holdings in our MAM portfolios generally have expense ratios from a third to more than a half percent per year lower than their category averages as reported by Morningstar. E.g., the top 4 domestic small cap holdings in all MAM portfolios have a weighted average OER of 0.92%, a savings of 0.55% compared to the reported Morningstar category average of 1.47%. The comparable savings are .32% for domestic large cap funds, and .49% for international funds.

a questionable investment approach. High turnover funds are further considered only in rare cases, regardless of the levels of recent performance. The average equity mutual fund turnover rate is close to 100%, which means they hold their stocks on average for only one year. I prefer funds with turnover in the 20% to 50% range (meaning average holding periods of 2 to 5 years per stock).

- Assets under management – Asset bloat was discussed earlier. There is no clear number at which the assets under management (AUM) become too high to continue to like a fund, since this depends on factors like market cap and investment approach. Small cap funds, and especially funds who earned their “stripes” when they were relatively concentrated funds, can be rejected outright for having allowed their AUM to spiral into the billions. High AUM’s are relatively less of a concern for larger cap funds and/or funds pursuing quantitative strategies that are designed to own hundreds of stocks.
- Manager tenure – All else equal we prefer funds with long tenured managers. But if the manager is relatively new to the fund, the key is to be sure we have access to the past history of the current manager, not just of the fund. The fund’s history under other managers may be irrelevant.

**Performance (to a degree)** - While we cannot rely wholly or even mostly on performance records for judging a manager, performance *does* count for something. At a minimum we should eliminate managers with very poor relative performance, since very poor performance does seem to persist. And good past performance does give *some* indication of good future performance, even if not nearly as much as we might hope – at least if we are careful to properly adjust for risk and to compare to an appropriate benchmark or class of peers<sup>7</sup>. So performance screens and quantitative analysis are a part of our research process, but just a part. I look at performance history in several ways, including:

- Relative performance over typical past periods like 1, 3 and 5 years.

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<sup>7</sup> Morningstar has done a good job of this in the past several years with its revised definitions of risk, benchmarks, asset classes and styles.

- Consistency of performance, measured by the percentage of rolling periods in which a manager outperforms, as well as being sure the record is not based on extreme short term bouts of great performance (a “career year” or two). As we have said, we cannot expect perfection on this score, but more consistency is better than less.
- Risk control - how well or poorly did the fund perform during recent bear market periods?
- Risk adjustment – consider risk adjusted measures of performance such as Sharpe ratios, standard deviations and Morningstar risk measures.

**Investment Approach** – To me, the most important factor in evaluating managers is their investment approach. The approach should be clearly defined and based on a well founded investment theory. Besides understanding it, I must develop confidence in the investment approach. I am not one who believes we should diversify over all of the popular investment approaches – only the ones I believe in<sup>8</sup>.

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*Understanding and believing in a manager’s investment approach is the most important factor in the selection process.*

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Further, the approach should be implemented via a structured process. A structured process can include subjective judgments, but they should be part of disciplined step-by-step process, as opposed to just picking stocks based on intuition or hunches.

Finally, it certainly helps if the manager can claim some unique aspect to their approach and/or some competitive edge over his or her peers.

*The bottom line is I have to understand and have confidence in a manager’s basic investment approach if I am going to select him or her for our portfolios.*

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<sup>8</sup> It is beyond the scope of this paper to document the kinds of approaches I do and do not believe in. But I will list a few. Most of our funds use some variant of fundamental investing, which includes classic value and growth-at-a-reasonable price approaches. Others include behavioral finance, quantitative fundamentals and fundamental indexing. On the other hand, I have never selected funds based on technical analysis, sector rotation, macro strategies, market timing, relative strength or growth for the sake of growth.

**Manager as a Person** – Regardless of what we may read about a manager, it helps to meet them in person. I have met or at least listened in person to the managers of almost all of the equity funds in our portfolios, some of them many times. Some of the personality traits I look for in managers that are:

- Well informed – The best managers can extemporaneously provide a detailed story about almost any company you can name.
- Analytical in nature
- Passionate about investing

**Communications** – It is important that the manager communicate well and frequently to his clientele. I look for:

- Informative and analytical commentary - The manager should be self critical at times and honestly discuss mistakes and periods of lagging performance.
- Availability – Availability varies widely among mutual fund managers. Some frequently make themselves very available to their clientele via talks at conferences, conference calls and even small group meetings (seminars, dinners, etc.) Some never do any of these things.

**Business Environment** – Some of our managers work for investment boutiques like Thornburg or Dodge and Cox. Others work for industry behemoths like Fidelity or American Funds. In general I prefer the former, but the specifics of each manager's business environment also matter. I look for managers who:

- Are highly focused on investment management. There may be some tradeoff between this and the availability trait above, but we should look for managers who consider themselves portfolio managers first and not marketing whizzes or famous commentators.
- Are part of a stable, collegial business culture
- Invest significant amounts of their own assets in the fund they manage
- Have incentives that are compatible with the shareholders' interests (as opposed say to maximizing AUM)

## ***How Do I Conduct the Search for Exceptional Managers?***

The search for exceptional fund managers is a major part of my job, and I believe it constitutes a large portion of the value added I provide for clients of Marshalla Asset Management. This search process includes my own direct research and analysis, along with my utilization of the research and due diligence of some highly respected third parties.

**My Own Research** - My own research includes:

- Extensive reading of commentary and articles by and about mutual fund managers. I use the criteria in the previous paragraphs to screen down to a select group of candidate managers, limited enough in numbers to enable more in-depth research. Some of the better managers provide illuminating articles about their approach and the reasons for their successes and failures. For others, the written communications tend to be mundane, defensive or overly oriented to marketing. Thus, I often find a manager's own writing to be an invaluable piece of the evaluation puzzle.
- Number crunching is part of it as well, as I have access to all the data one could hope for regarding fund characteristics and track records. I won't force the details on you here, but rest assured my lifelong analytical inclinations have not withered on this job.
- Participating in live discussions with the managers - Most managers provide quarterly conference calls for advisors. Also, I typically attend three or four investment or financial planning conferences a year, the best of which enable multiple ways of listening to and communicating with fund managers. This includes presentations and panels, exhibit hall discussions, and small group dinners and breakfasts. Finally, many fund companies assign a representative to be a regular point of contact with individual advisors like me. In fact, there are so many opportunities to talk with fund managers or their representatives that sometimes the challenge is deciding how to limit the time so expended.

In addition to all this, my evaluation of fund managers is greatly leveraged by utilization of some excellent third party research sources. The two that stand

out are Morningstar and the Litman/Gregory Company.

**Morningstar** – Just about everyone is familiar with Morningstar to one degree or another, especially with its ubiquitous mutual fund star ratings. But beyond the star ratings, Morningstar offers a large range of investment products, geared separately to advisors and retail investors, including newsletters, online services, databases, and both web and PC based software. I believe Morningstar is the predominant provider of investment information for independent advisors as well as retail investors.

Morningstar offers both hard data and qualitative analysis and opinions about virtually every mutual fund we might want to consider. Among the more useful services is their attempt to whittle the thousands of available funds down into lists of “Analysts Picks” within each fund category (like small cap value or large cap growth). Morningstar analysts use a process similar to the one I have outlined herein to identify their own favorite funds, and the selected funds are not necessarily five or even four star funds. While I do not consider the Analyst Pick designation a primary factor in selecting funds, I do give it significant weight.

I have long wondered whether the funds selected as Morningstar Analyst Picks would indeed turn out to be better than average risk-adjusted performers. I was pleasantly surprised when Morningstar published a study about this just last month in one of their newsletters<sup>9</sup>. While this study hardly settles the matter, it provides a reasonable first cut at the question, and the initial results are promising.

The study examined the relative performance of the Analyst Picks over the subsequent three and five year periods following their selection, comparing their raw and risk adjusted returns to those of their peers within their given Morningstar category. Amongst the 27 categories of stock and bond funds evaluated, the researchers found that 67% of the overall Analyst Picks beat their category performance averages in both the subsequent three and five year periods. If we confine ourselves to the 9 categories of domestic equity funds, the results were somewhat less impressive, though still positive. The batting averages for domestic equity fund Analyst Picks were 60% for

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<sup>9</sup> “Fund Analyst Picks Thump Category Averages”, by Russell Kinnel, in Morningstar FundInvestor, Sept., 2006, p.1-3

the subsequent three years and 55% for the next five years<sup>10</sup>. Also, the study reported that over the three years following their selection, only 14% of the Analyst Picks funds ended up in the bottom quartile of their categories, while 41% came out in the top quartile. For the subsequent five year period, only 12% came out in the bottom quartile, while 36% achieved top quartile status<sup>11</sup>.

I cite Morningstar’s Analyst Picks list as just one example of the many ways I use Morningstar data, tools and analysis to leverage my research on mutual fund managers. There are many others, such as screening tools, portfolio X-rays, holdings-based analyses of investment styles, and qualitative discussions of fund investment strategies, track records, manager histories, risks and other issues. It would be hard to imagine life as an independent advisor without a resource like Morningstar.

**Litman/Gregory** – Morningstar seeks to be a comprehensive data source for everyman. Given this mission, I believe it does a fine job covering an amazingly large universe of mutual funds. But any research effort that applies itself to some 11,000 subjects will necessarily be somewhat limited in depth of research.

A wonderful alternative for someone seeking more depth as opposed to breadth is a service I subscribe to by the Litman/Gregory (LG) Company. Called “Advisor Intelligence”, this is a service offered specifically for advisors. It is expensive, but well worth it. It provides me with access to all of LG’s mutual fund, asset class and other investment research, the same as if I were a member of the company. It also brings with it a continual stream of invitations to small group meetings with mutual fund managers and the LG researchers themselves. The number of mutual funds analyzed is far smaller than Morningstar’s universe, but the depth of analysis and due diligence is much, much deeper. Their due diligence process is so intense, including exhaustive lists of written questions and long in-person meetings with the managers and analysts, that sometimes I am

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<sup>10</sup> The low five year score was pulled down six points by an inexplicably low score of only 11% for the small cap value category – possibly an outcome due to improper benchmarking.

<sup>11</sup> The article does not break this down to show how the result may have differed as to stock and bond funds.

surprised the mutual fund companies even agree to participate. LG is not a large firm, but I consider it to be a world class research source.

As I have discussed the many factors I look for in mutual fund managers, you may have wondered how one person would have the time and access to check out all these factors for the dozens of mutual funds on my list of potential candidates. And how would I know, for example, if the fund company has a “stable

and collegial business culture”, or what the non-investment responsibilities of the managers may be? Now you know the answer. In subscribing to Advisor Intelligence, I am able to leverage all of their in-person due diligence into my own, and thereby help to identify a stable of exceptional fund managers that provide the backbone of our investment portfolios.

## *Summary and Conclusion*

Unfortunately, finding exceptional equity managers or mutual funds for which good relative performance is likely to persist is not as easy as looking up their past performance. It helps if we consider risk-adjusted performance, and compare it to the appropriate benchmarks and peer groups, but this is still not enough. Although it is difficult to discern long term persistence of above average returns in the aggregate data, this does not prove it does not exist for some small set of managers, and it is my belief that we can find these managers.

Past performance *is* a factor in selecting mutual funds for our portfolios, but it is only a one component of the process. Finding exceptional managers requires a deeper level of research: getting to know the managers and understanding and appreciating their investment disciplines, screening out high cost, high turnover funds and those who allow assets under management to grow too large and who are more interested in marketing than investing. The search for exceptional managers is a large and continuing part of the job I do for clients at MAM. Today’s information economy provides me with remarkably good access to investment data, extensive communication opportunities with the principals, and accessibility to world class third-party research sources which allow me to leverage my research. It is my hope and belief that the result of all this will be the discovery of persistently exceptional managers.