

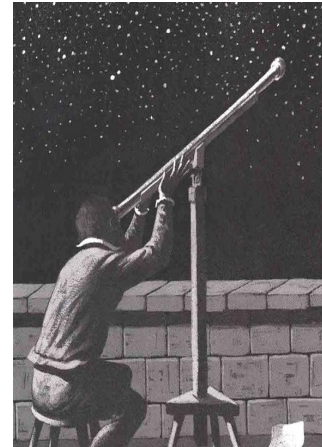
FALLING STARS

September 2010

Ordinary is not nearly as interesting as extraordinary. Extraordinary sells. Ordinary does not. This is one reason that the press covers the stars of the entertainment, sports, and political world far more than regular citizens. The financial press rarely profiles underperforming investment managers unless they totally collapsed or committed fraud.

At Moisand Fitzgerald Tamayo, we do not give much credence to the star manager. Their stars usually fade. Many that looked skilled were just lucky. A number of studies of mutual fund performance show that you have a better chance of picking a fund that will end up a top performer by throwing darts at a list of funds than using past top performance as a selection screen. (See our June 2009 commentary “No Gurus” at moisand-fitzgerald.com).

Anecdotes and a nice story can be entertaining but they do not amount to a reason for us to commit any client capital to a star manager. When we see a manager outperform their respective category to any significant degree, we immediately get suspicious. Looking beyond the glossy press coverage, we often find things we do not like. One of the most common causes of the outperformance that we dislike is miscategorization due to managerial changes.



Imagine that you are an up and coming gourmet chef. In attendance tonight will be the person you admire most in the world, the person you love more than anyone in the world, and the most influential food critic in your area. The quality of what you prepare has never been more important both personally and professionally. You create a menu of your best dishes and send your assistant to the market so everything is as fresh as possible.

When your assistant returns, he has different items than you wanted. How would you feel about this? Most chefs in that situation would be very unhappy. The assistant defends his deviations based on saving some money on cheaper offerings of ingredients you wanted and selecting other ingredients not on your list because they looked good. While the intent may have been admirable, you are probably still not very happy. After all, you made your selections based on very specific needs and criteria.

Our clients' needs are our top priority. It is important to us that your holdings have the best chance of success we can find. When we create a portfolio, we have very specific criteria for its components. One of them is that the manager will be invested in the types of securities we want for that portion of the portfolio. Often when a high performing manager is profiled, you will see that he was not invested in the same types of securities as other managers in his category.

Not long ago we came across a man profiled as “one of the top performing US small cap fund managers”. He was being lauded for shifting 25% of the fund to foreign stocks. The fund holders made money, so what is the problem? Glad you asked.

Looking strictly at the results, the fund did well but not for the reason suggested by the category ranking. If there were a category for funds with 75% in US small company stocks and 25% foreign stocks, this fund would have received a mediocre category ranking. The majority of the results generally came from the shift into the foreign stocks, not from any superiority of the individual stocks picked.

From a portfolio design and implementation standpoint, it makes no sense for us to carefully determine what types and how much risk a portfolio should bear only to implement the design in such a way that we have no control over these risk factors. If we want a client to have x% exposure to an asset class, by golly we want x% in that asset class. We will use a vehicle that is fully invested exclusively in those types of stocks so we can be assured that our client has the exposure we intended. Using a manager with a “go anywhere” approach would be like the chef telling his assistant to get whatever he wants and cook it anyway he pleases. It may turn out fine but if the meal is a failure it will be the chef’s hide on the line.

If you were the food critic that got a lousy meal and the chef said it was the assistant that did it all, would you dismiss that or might you ask, “Well who hired him and give him that capability, Chef? Would you be likely to include in your review the chef’s bad judgment? What are the chances you would recommend a restaurant whose head chef had no clue what was being served?”

When it comes to money however, too many people would let such a thing slide. If they make money from a manager’s moves, the end justifies the means. “What do I care? It made me money,” they might say without realizing they just said it was OK to do practically anything with their money without telling them. Do you think Bernie Madoff’s customers still think that way?

Fraud issues aside, big bets mean big risks. By definition, a list of top performers doesn’t identify poor performers. A look at the worst performers in a given category often finds funds that deviated from their category too and their bets lost. Their intent may have been good but they did not maintain the risk profile they were supposed to, incurred higher costs and in many cases resulted in unexpected taxation.

Too many people attribute investment success to skill when luck should really get the credit. You can’t buy anything without someone taking the exact opposite position and selling. People have a tendency to judge the quality of a decision based on the outcome and view things as far more predictable than they really are. Good outcome means good decision. Bad outcome means bad decision.



In a classic psychology study, two groups of people were given identical fact patterns regarding a business project and asked to judge the quality of the decision made in the illustration. One group was told the decision worked out well. The other was told the project failed. Despite the exact same fact pattern and exact same decision, the group that was told the project succeeded gave the decision a positive rating four times as often as the group that thought the project failed. We see a similar dynamic in sports. When a team goes for it and succeeds, the coach is praised for being bold. If they go for it and fail, it was a dumb call.

While we often apply hindsight inappropriately, we do value discipline. How many movies, books, and plays feature a hot shot that doesn’t listen to his superiors and causes trouble for everyone? Later, thrust into a situation that requires the discipline he failed to exercise earlier, the hero does what he was supposed to and everyone wins. Did anyone really think Maverick was going to leave his wingman at the end of Top Gun? Of course not, he stuck to his discipline and helped win the battle. Cue the uplifting music.

We expect the providers of the products we use to do exactly what we hired them to do. We demand transparency so we can be assured they are doing just that. We want to keep costs down and we want as much control over the taxes that a portfolio generates as is wise given a client’s unique circumstances.

These factors explain why we routinely rebuff the pitches of people who want your money for their hedge funds, expensive or poorly designed annuities, packaged private equity investments, managed futures programs and similar costly, illiquid, speculative or non-transparent vehicles. We have yet to be disappointed by “missing out” on anything. Most of the time, all we missed out on was poor results.

Though many have tried, no one has yet been able to predict major market moves consistently enough to overcome the costs of moving in and out of the market over a meaningful time frame. We cannot control what our returns will be. However, we can make risk management a priority and restrict our investment choices to those that accurately reflect the risks we wish to accept. Diversification, patience, and discipline - all three are needed all the time.

