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Senior Consultant

The Voice of the Investment Management Consultant

[ G r a p h i c o m i t t e d ]

# Consistency Pays Long-Term Dividends

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The late 90's caused much consternation with our research committee. We had always believed in style neutrality, but our belief was being severely tested as Growth beat Value year in and year out. Further, as we evaluated the best performing managers in the country, they had one thing in common – heavy concentration in technology. We are grateful that we stuck to our guns and did not succumb to the Growth concentration craze. But just as rewarding was our focus on managers who did not make big bets in technology (or any particular sector for that matter). We do believe that there are managers who have a talent in investing in top-down themes, but we believe managers who sector-concentrate should be limited in an overall portfolio.

Diversification has won out. It has not necessarily kept investors from losing but has certainly cushioned the blow in arguably the worst stock market since the Great Depression. There is no doubt that bonds and value stocks have been the saving grace, but our asset allocation focus has not stopped our quest for finding superior managers and products.

What we have learned is that, by and large, those managers who lived by the big bets in the 1990's were mostly hurt by those bets in the early 2000's. The lesson: Big bets are usually not worth it. We have always believed that managers who consistently "do a little better" are the winners. An important quantitative analysis when evaluating managers is a calendar year consistency screen. In other words, how often has a manager outperformed its peer group over calendar years? Typically, if a manager outperforms his peers consistently in short periods, regardless of the margin, long-term cumulative performance will shine. The problem is that most investment magazines and rating services evaluate only cumulative performance over various timeframes. Consequently, a couple of huge years, relatively speaking, can make cumulative performance stellar. Often, these big years come with significant bets, and investors can be sorely disappointed when investing based on this limited analysis. Cumulative performance, including risk-adjusted performance should be analyzed, but is a small component in evaluating the quantitative aspects of performance. Qualitative evaluation is even more important which entails understanding the firm's investment philosophy and process. This involves interviewing the manager to understand the procedures in place and to determine if the investment results are a repeatable process and not just luck.

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## Proving the Point

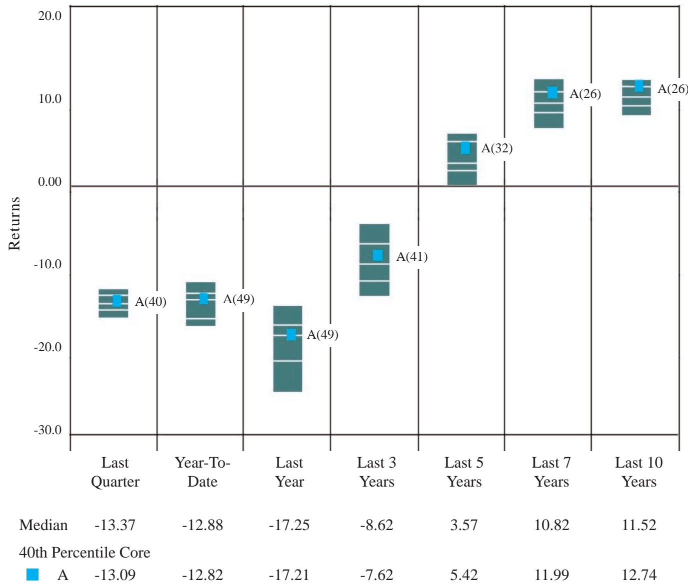
We built hypothetical track records of managers from seven distinct style groups. We used Callan Associates' database universe which is structured in a way to eliminate "survivorship bias". The universes are extremely pure, and a manager would have to cease to exist entirely in order to be automatically dropped from the universe. If this were not the case, there would be a survivorship bias as underperforming products would be dropped from the style universe, only to be replaced by relatively better performing products over time.

Our hypothetical managers each had quarterly performance ranking in the 40th percentile against their peer group (outperforming 60% of the managers). Most investors, we believe, would argue that the 40th percentile is mediocre. We linked these 40th percentile quarterly returns to build a long-term composite. Our study included the following manager universes: Large Cap Value Equity, Large Cap Growth, Large Cap Core, Broad Mid Cap, Broad Small Cap, Core Fixed Income and Core Non-U.S. Equity. We linked 40th percentile returns for each manager going back quarterly for 10 years.

The results of our analysis are very consistent (see Figures 1 through 7). Regardless of style, a manager who “consistently does a little better” will have stellar long-term results. In each style groups, 10-year returns ranged from the top 2% of all managers for Small Cap to the top 26% for Large Cap Core.

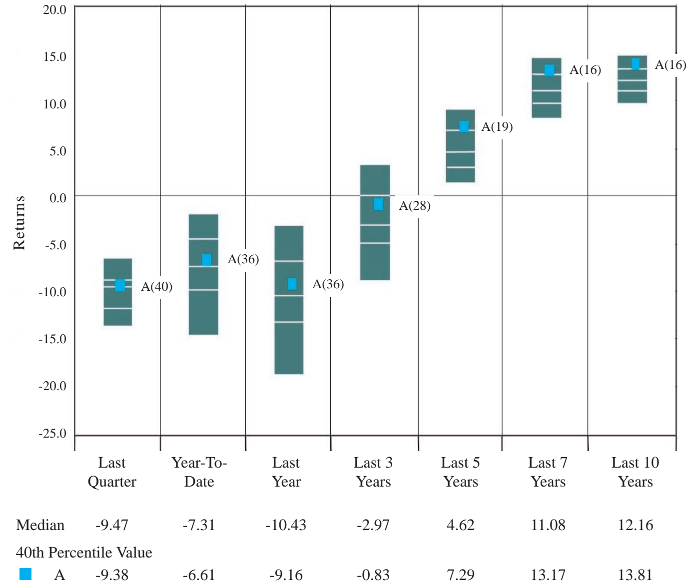
[ Graphic omitted ]

### Figure 1.
### Returns for Periods Ending June 30, 2002
### Group: CAI Large Cap Core Style



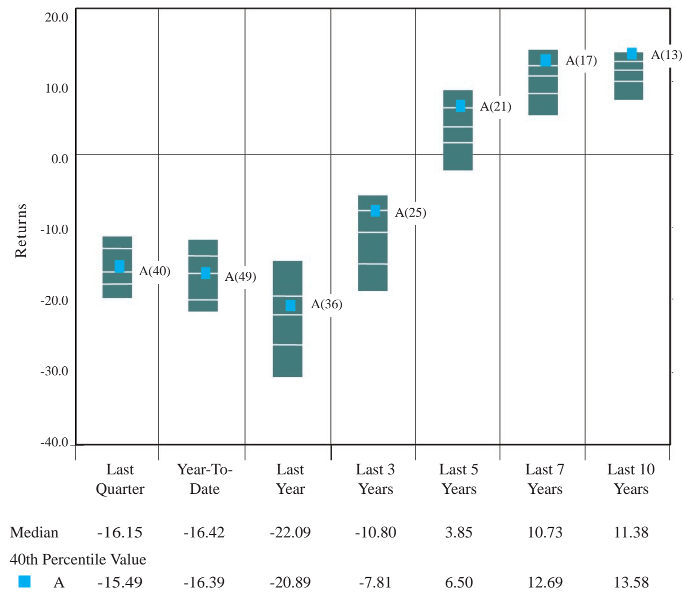

| | Last Quarter | Year-To-Date | Last Year | Last 3 Years | Last 5 Years | Last 7 Years | Last 10 Years |
|---|---|---|---|---|---|---|---|
| Median | -13.37 | -12.88 | -17.25 | -8.62 | 3.57 | 10.82 | 11.52 |
| 40th Percentile Core | | | | | | | |
| ■ A | -13.09 | -12.82 | -17.21 | -7.62 | 5.42 | 11.99 | 12.74 |

### Figure 2.
### Returns for Periods Ending June 30, 2002
### Group: CAI Large Cap Value Style



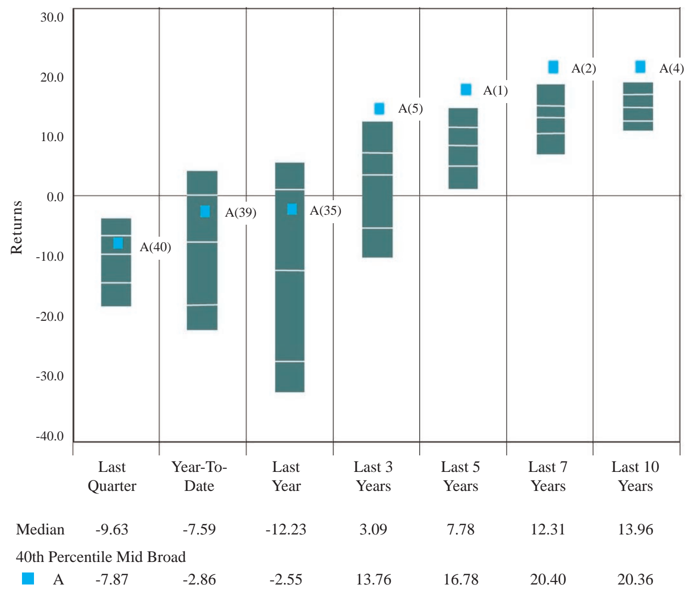

| | Last Quarter | Year-To-Date | Last Year | Last 3 Years | Last 5 Years | Last 7 Years | Last 10 Years |
|---|---|---|---|---|---|---|---|
| Median | -9.47 | -7.31 | -10.43 | -2.97 | 4.62 | 11.08 | 12.16 |
| 40th Percentile Value | | | | | | | |
| ■ A | -9.38 | -6.61 | -9.16 | -0.83 | 7.29 | 13.17 | 13.81 |

### Figure 3.
### Returns for Periods Ending June 30, 2002
### Group: CAI Large Cap Growth Style




| | Last Quarter | Year-To-Date | Last Year | Last 3 Years | Last 5 Years | Last 7 Years | Last 10 Years |
|---|---|---|---|---|---|---|---|
| Median | -16.15 | -16.42 | -22.09 | -10.80 | 3.85 | 10.73 | 11.38 |
| 40th Percentile Value | | | | | | | |
| ■ A | -15.49 | -16.39 | -20.89 | -7.81 | 6.50 | 12.69 | 13.58 |

### Figure 4.
### Returns for Periods Ending June 30, 2002
### Group: CAI Mid-Capitalization Style




| | Last Quarter | Year-To-Date | Last Year | Last 3 Years | Last 5 Years | Last 7 Years | Last 10 Years |
|---|---|---|---|---|---|---|---|
| Median | -9.63 | -7.59 | -12.23 | 3.09 | 7.78 | 12.31 | 13.96 |
| 40th Percentile Mid Broad | | | | | | | |
| ■ A | -7.87 | -2.86 | -2.55 | 13.76 | 16.78 | 20.40 | 20.36 |



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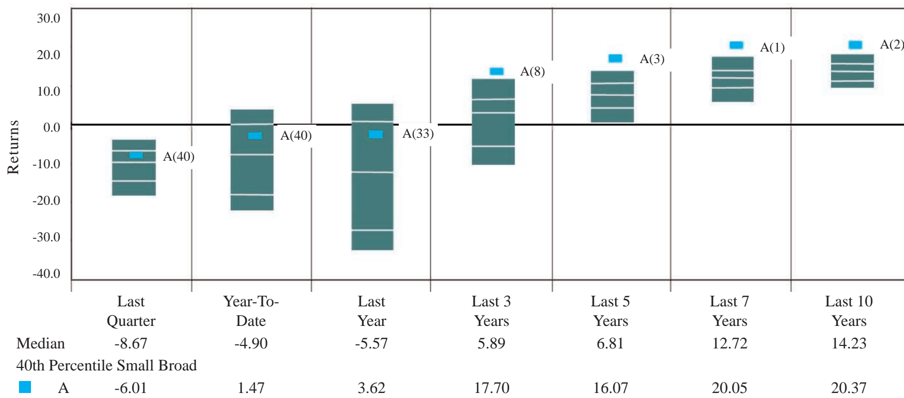
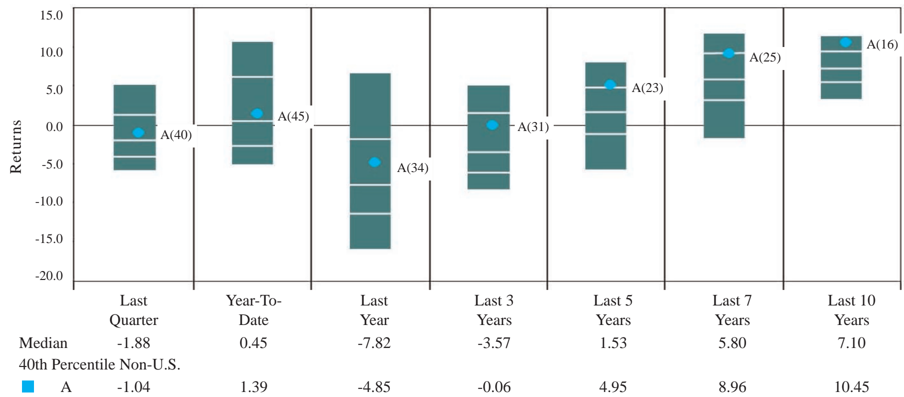
Figure 5.
Returns for Periods Ending June 30, 2002
Group: CAI Small Capitalization Style



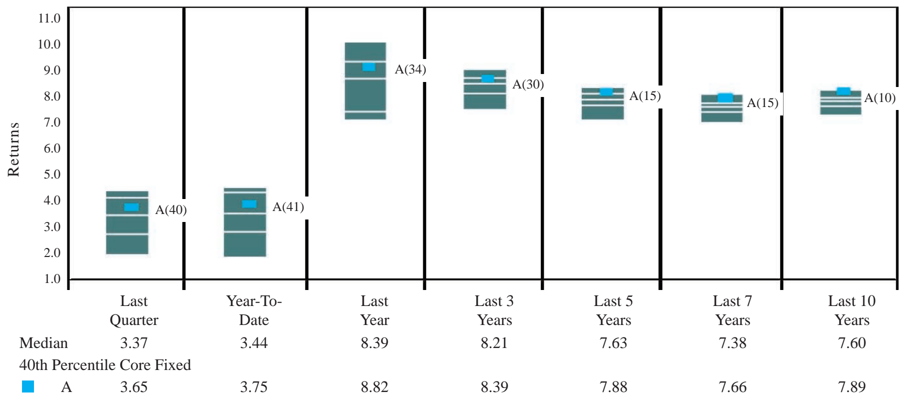

| | Last Quarter | Year-To-Date | Last Year | Last 3 Years | Last 5 Years | Last 7 Years | Last 10 Years |
|---|---|---|---|---|---|---|---|
| Median | -8.67 | -4.90 | -5.57 | 5.89 | 6.81 | 12.72 | 14.23 |
| 40th Percentile Small Broad | | | | | | | |
| ■ A | -6.01 | 1.47 | 3.62 | 17.70 | 16.07 | 20.05 | 20.37 |

Figure 6.
Returns for Periods Ending June 30, 2002
Group: CAI Non-U.S. Equity Database




| | Last Quarter | Year-To-Date | Last Year | Last 3 Years | Last 5 Years | Last 7 Years | Last 10 Years |
|---|---|---|---|---|---|---|---|
| Median | -1.88 | 0.45 | -7.82 | -3.57 | 1.53 | 5.80 | 7.10 |
| 40th Percentile Non-U.S. | | | | | | | |
| ■ A | -1.04 | 1.39 | -4.85 | -0.06 | 4.95 | 8.96 | 10.45 |

Figure 7.
Returns for Periods Ending June 30, 2002
Group: CAI Core Bond Fixed-Income Style




| | Last Quarter | Year-To-Date | Last Year | Last 3 Years | Last 5 Years | Last 7 Years | Last 10 Years |
|---|---|---|---|---|---|---|---|
| Median | 3.37 | 3.44 | 8.39 | 8.21 | 7.63 | 7.38 | 7.60 |
| 40th Percentile Core Fixed | | | | | | | |
| ■ A | 3.65 | 3.75 | 8.82 | 8.39 | 7.88 | 7.66 | 7.89 |

## Conclusion

Investors should focus on managers who provide performance consistency in their own style group. Although, big bets may pay, little tracking error relatively to that style group is a big winner. Performance can be analyzed in lots of ways, but slightly above-average return consistency can be a key indicator of real manager success. ■

## About the Authors

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