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H. Bradlee Perry
Marble Harbor Investment Counsel Advisory Board Member
Investment Consultant

Evaluating Investment Performance

Americans love to keep score – whether it's for sports teams and the performance of their players, the changing rank of billionaires (as compiled by *Forbes* magazine), or in a more serious vein evaluating corporate profits and assessing the figures in government budgets, or many other things. But nowadays no group is more obsessed with "how'm I doing" than investors.

As I pointed out last October (in "It's A New Ball Game"), computers now enable us to measure portfolio performance literally from day to day and minute to minute. And the result of this capability has been a greatly shortened performance focus by investors – from years down to quarters, and even weeks in the case of mutual funds. (To monitor them, every Saturday morning hundreds of thousands of investors pick up Barron's to peruse its Market Week section to see how their mutual funds did in the latest week.)

Recently I was reminded of this big shift toward the short term while lunching with an old friend, when he said, "I'm a little concerned about my investment manager. He hasn't done very well in the last few quarters, and in 2012 my account lagged 1.6% behind the S&P 500. That's the second time in the four years since 2008 that I've fallen short, and in the other two years I was ahead of the S&P by just 0.9% and 1.4%. So there's been a real slowdown recently."

I replied that he was talking about a pretty short period and I asked him how his account had done over a longer time. He responded, "Oh, I don't think so much about that as about the recent past, but going back over time I guess it's been pretty decent. However, the latest years of mediocre performance concern me." I told him I thought he had a good manager, but if he would send me his performance record for a longer period, I could tell him how I thought his manager has been serving him. The next day he sent me his performance data, covering the history of his portfolio since he started with his current manager.

Recognizing that comprehensive studies show that *a majority* of all professional equity investment managers (of both mutual funds and separately managed accounts) *underperform* the stock market in the long run (as I also said in October), the record of my friend's account looked very good over the past seven years. And this manager achieved a particularly desirable result during that period: greatly *outperforming* the stock market in the big crash of 2008.

Falling much less in bear markets *gives a client reassurance* in the unnerving periods when many investors get so scared that they want to give up on stocks and often take defensive action, far too late, that ends up hurting their long-term performance. And beyond just the psychological comfort factor, holding up well in plunging markets is *key to long-run investment success*. If your portfolio declines less than the market, it doesn't have to subsequently recover as much as more volatile portfolios do to end up with superior long-term performance. My friend didn't realize that until I explained it to him.

The real lesson of his performance numbers is what experienced investors have known for a long time: <u>The only valid way to measure investment results is over a full stock market cycle</u>, from high to low and up to the next high. What the shorter, interim periods look like is irrelevant. Long-term performance is all that matters.

Stock market cycles usually coincide, at least roughly, with economic cycles, and each one consists of a variety of conditions, good and bad. These variations obviously affect year-to-year stock moves, which can be quite erratic, but they tend to cancel each other out to a great extent over the full cycle.

The primary goals for almost every investment program, whether for an individual or an institution, are definitely long-term. So how a portfolio performs cumulatively over many years – through good and bad market conditions – is the overriding consideration. In the second conversation with my friend, I showed him how well his portfolio had performed over the latest full market cycle, and he began to see the magnitude of his success.

Beating the S&P by ten percentage points during the most turbulent period any of us can remember – as his manager did – is really superb, top-rank performance. So he should be very pleased with his manager (as he started to realize). But if this gentleman is like most investors, he'll probably still keep a close watch on his quarterly and annual results, thinking short term before long term.

"What have you done for me lately?" is the normal mind-set of investors in today's short-term-oriented world. It's just hard to get away from it. To overcome that attitude, I always explain to investors that they are running a *marathon*, not a series of short *sprints*. No sprinter, however hard he may try, can ever win (or even finish) a race 26 miles, 385 yards long.

When evaluating investment performance, it's also important to look behind the numbers and analyze *how* a manager has achieved what the figures show. This can provide clues as to how much risk has been incurred, how much common sense has been used, and how sustainable the past results may be in the future.

Most important, if the manager has used a consistent, sensible strategy throughout the full market cycle, the performance of the portfolio clearly indicates the effectiveness of his basic strategy. And if he continues to follow that investment approach, future results are likely to be fairly similar – unless there's a major change in the nature of the stock market. That happens in rare instances, but not often.

Clients have varying degrees of investment knowledge, but everyone should try to understand their manager's strategy and determine as best they can if it's grounded in logic and common sense. And it's the manager's responsibility to explain his approach clearly and completely.

Obviously, managers who trade stocks in and out of accounts at rapid rates are trying to *guess* possible short-term price moves, a difficult task that entails considerable risks. Also uncertain is the approach of frequently altering strategies in an attempt to keep up with intermediate, often minor, shifts in the market. Such "*tactical*" moves (watch out for that word, it's a warning signal) show that managers are making short-term moves based often on transitory factors, and just following the crowd. That tends to lead to erratic behavior and poor odds for long-term success. It may be appropriate to evaluate a manager with a high-turnover strategy over short time horizons, but for a manager who measures ownership in years, a full market cycle is more relevant.

You can learn a lot about a manager's strategy by discussing it at the outset of your relationship, and continuing discussions as time goes along. These will indicate if he's changing his basic approach, and if so, why. Another way to gain understanding about this key matter is to see if the nature of the stocks in your portfolio is staying the same or changing – and if the latter, ask why.

"Style drift" became a real problem with many managers in the late 1990s, as the building fever of the technology boom lured them to greatly increase their holdings of tech stocks – many of which were exciting new companies that no one had even heard of a year or two earlier. Obviously these were risky investments. But that fact was largely overlooked by managers and their clients as the technology rocket soared happily into the stratosphere – where, inevitably, it eventually exploded.

For a while, this was a big, highly rewarding game that everyone wanted to be in. And investors were reassured – thrilled actually – by the wonderful short-term performance they were achieving. But unfortunately they overlooked the business risks and market valuation risks behind their great performance numbers until it was too late – when the bubble suddenly burst in 2000. This was a costly deviation from many sound earlier investment strategies.

Getting back to my friend's portfolio, its performance figures from 2006 to 2012, and especially in 2008, indicate that his account was concentrated in strong, high-quality companies that tend to produce good business results just about every year – rarely spectacular but very solid most of the time, and often regardless of economic conditions. These are the Blue Chips I refer to frequently. A look at his portfolio list confirmed my assumption about the kind of stocks he owned.

These high-grade stocks were totally suitable for a client whose long-term needs can be met with steady, decent performance over the long run. Like many fortunate people today, after the very rewarding major stock market advance in the 1980s and 1990s, followed by the recent market recovery after its huge interim plunge, he has enough capital that he doesn't have to build it up lots more to meet his essential needs. He doesn't have to swing for the fences, which usually produces more strike-outs than extra-base hits.

True, he does have increasing requirements to enable his growing family to live comfortably in the future, but those can be met by steady, unspectacular capital appreciation – hopefully a little faster than the market, but not off the charts. (Younger investors, trying to build capital for their retirement, do have higher goals, but in today's uncertain, risky world they, too, should follow a relatively safe investment approach built on the solid foundation of high-quality stocks, and funded in part by substantial savings out of their current income.)

All investors should avoid getting caught up in the fever of the performance derby. To repeat, they should look at their results on a sensible, long-term basis. And they should seek managers who follow proven investment strategies that entail low risks. Being prepared to live with occasional years of subpar performance is important; those are just normal occurrences and nothing to worry about.

Even with a record lifetime batting average of .344 (including hitting .406 in 1941), Ted Williams sometimes went through slumps, lasting days or even weeks, when he struck out or flied out many more times than he got on base or hit home runs. But he never panicked or changed his swing. He just kept swinging at the ball in his well-honed, regular fashion (analogous to an investment manager's consistent, sensible strategy). And his long-term performance was undeniably excellent – the best. Probably there are no investment managers as outstanding as Ted Williams; he was exceptional. But investment managers who approach their craft the way he did should be good long-term performers.

Patience and perspective are two of the key attributes of successful investors. And they are essential in evaluating portfolio performance. So relax a bit as you follow the stream of quarterly and annual performance reports you receive on your portfolio. And always try to understand what's behind the longer-term results. Being well informed and realistic helps clients analyze their performance intelligently.

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Marble Harbor Investment Counsel, LLC
101 Federal Street, Suite 2505
Boston, MA 02110
617-956-6710
www.MarbleHarborIC.com