



Risk Adjusted Mutual Fund Performance

In response to a comment by New York Attorney General Eliot Spitzer that “Investors should move their money from one fund to another depending on performance and pricing in a much more aggressive manner than they currently do.,” the highly regarded manager of the Jensen Portfolio replied, “With all due respect, Mr. Spitzer may be echoing a modern investment fallacy by thinking of the market as a *lottery*. If even numbers don’t win, try odd. If your fund didn’t outperform the market last year, switch to one that did. But then, just how are investors to know if they own a rotten apple or a golden one? There is no one alive who can reasonably predict the best performing funds for the next one, two, three, five or ten years, despite what magazine publishers decree. Neither is there anyone that can predict what the market will do over those same periods. It is quite likely there will be some legitimate hot hands, and it is assuredly true there will be some legitimate cold ones.” Recognizing the truth of the often made assertion that “Past performance is not necessarily an indication of future performance,” what is an investor to do? One renown investor wrote that he would choose an investment manager much the same way he would select a law firm, doctor or accountant. Find people with integrity, experience and dedication that are respected by their clients. Would that we were all in a position to do just that! Sadly, however, not many of us are able to go out and interview mutual fund managers or receive the kind of personal referrals on which we rely to select doctors, lawyers, or even plumbers! But if, indeed, past performance is no indication of future results, what is the use of pouring over mutual fund statistics? Just select a fund that looks pretty good at the time, buy it and stick it away, letting time and compound interest take its course. We are convinced there is a better and more sensible alternative, but much depends on the definition of “performance.” If by performance is meant, as is all too often the case, very high returns earned over some relatively short and recent time span, then we would agree wholeheartedly that past performance, particularly a mutual fund’s most recent past performance, is of very little, if any, value in indicating future results. Any fund manager, simply by taking enough chances coupled with a little luck, can earn abnormally high returns for brief periods of time, and many managers are also fortunate enough to enjoy some prolonged lucky streaks that seem to virtually guarantee their future success as well. Even mutual fund managers win the lottery occasionally!

But most often, “You get what you pay for,” in investing, just as in life in general. That is why we define “performance” in a very special way, most commonly referred to as *risk adjusted performance*. Risk adjusted performance is a *relative*, not an absolute, way of looking at mutual fund returns. It also rests squarely on the belief that, with few not-to-be-counted-on exceptions, the return earned on an investment depends directly on the risk it presents. Here, then, the focus is not on how much a fund earns but on how much it earns relative to the risk taken. We think the evidence is clear that consistently high *risk adjusted* rates of return are indicative of future such results because they are generally achieved independently of broad economic trends and market behavior, and are achieved by investment approaches characterized by disciplined and *repeatable* behavior. How do we go about finding funds that exhibit superior risk adjusted performance? We *look* for them, and we look very carefully. At the present time, there are over 17,000 mutual funds of various kinds and “looking” requires a carefully constructed computer based screening procedure. What we are searching for in our screening process are those funds which, when compared with similar funds, as defined by investment style characteristics, have actually exhibited higher rates of return accompanied by lower levels of risk than the average fund in the particular category being screened, and which have accomplished that feat over a long enough period of time to be meaningful. Since there are anywhere from several hundred to over a thousand different funds in each investment style category, reducing the funds for further consideration to those that are at least *better than average* is an effective first step. Specifically, we initially search over 3 and 5 year time periods and require, in each case, that the existing fund manager be at the helm for the entire period covered, or that the fund employs a *committee* structure that is clearly defined. There is no point in counting on a new manager to repeat somebody else’s performance, risk adjusted or otherwise! The screen that attracts our primary attention is one that imposes the

requirement that a fund exhibit better than average risk adjusted performance for *both* the most recent 3 and 5 year time periods. We do so to make sure that a fund which looks appealing over the full 5 year period has not just benefited from an unusually strong result achieved very early in that period; that is, that the fund is not coasting on out dated results. At the same time, we want to become aware of funds that are *early* in the process of demonstrating superior investment management, and we do so by looking carefully and selectively at the results of a shorter 3 year screen. Most of the funds shown only on the 3 year screen are placed on a watch list and very few survive to accompany the funds from the longer 3 and 5 year screen for further consideration. Most of our selections for further consideration come from the initial screen involving both 3 and 5 year time periods.

Unlike most of the screens that you read about in the financial press or see on the Internet, we do not impose collateral criteria such as asset size, fund expense, tax efficiency, number of securities held and some of the other characteristics of a mutual fund that are often used in such screens. The reason for our not doing so is that what we are looking for initially is proven *results* only. How those results might have been achieved, and thus how likely are to be repeated, is the subject for later analysis where we use such characteristics to good effect because they are, indeed, valuable indicators of future superior performance. For example, other things being equal, a fund with a lower overall expense ratio is more likely to continue to demonstrate superior performance than one which charges more. However, there are exceptional funds from a risk adjusted return perspective that demonstrate consistently outstanding performance and charge more for it. There are also outstanding funds that are not especially tax efficient. Also, we think that funds with more concentrated portfolios are more likely to demonstrate future exceptional performance simply because *they are the exception*, as contrasted with the huge number of securities held in the "index hugging" funds. Once again, however, "the exception proves the rule." There are some truly superior performing funds with large holdings. The widely proclaimed hindrance to effective portfolio management that comes when a fund suddenly becoming bloated in size is a problem that we recognize, but here again, there are exceptions. The list goes on, and we do not want to "out smart" ourselves in the early stages of our screening process by specifying "how" superior risk adjusted performance has been achieved. We want to leave those refinements for later and very careful examination. The results from our initial screens can vary from a mere handful to over a hundred, depending on the number of funds in the investment style category. Culling the list to a manageable size is usually not too complicated, as the initial screen, simple and straightforward as it may be, cuts the list of all the available funds in any investment style category greatly. Remember, to do "better than average" by our *risk adjusted* criteria does not mean simply that a fund falls in one half of its category. Typically, our initial screens reduce the total style category list to 10 to 20 percent of the original number. Next, having unearthed what we expect to be promising funds, we want to subject each prospect to a strict comparison. We are not satisfied by just finding "good" funds, we want, as nearly as possible, to find the "best" funds in each category as measured by our risk adjusted standards. Therefore, we submit each fund coming out of the early screens to another screen where the *fund itself*, not the average for the style category as was true for the first screens, becomes the basis for comparison. The second screen, then, looks for all those funds that might have a better risk adjusted performance than the particular fund under consideration. The second screening process is similar to the first, but different in a critically important way. There is a statistic, called the *Sharpe Ratio* and available in any good mutual fund data base, that relates risk to return in a simple, intuitive and meaningful way. The Sharpe Ratio is just that, a *ratio*, that relates a fund's rate of return over the time period covered to its standard deviation, a measure of variability, or uncertainty, of return. Since, for most people, the notion of uncertainty about future results captures much of what they think of as risk in investing, the Sharpe Ratio simply relates two numbers that represent the risk and reward offered by the fund over the time period for which the ratio is calculated. By dividing the rate of return by the standard deviation of return, the Sharpe Ratio provides a simple measure that expresses "the unit of return earned for each unit of risk taken." It offers a simple and succinct "one size fits all" number for revealing a mutual fund's risk adjusted rate of return. The Sharpe Ratio is not a

perfect measure of superior investment performance, but it conveys a great deal of useful information in a concise manner. How we use the Sharpe Ratio in the second round of screening presents a different "take" on the issue of risk adjusted investment performance. Recall that the initial screen, which every fund has to pass before being further considered, requires that the fund have a higher rate of return *and* a lower standard deviation than the average fund for its category. Both criteria have to be simultaneously satisfied to pass the initial screening. What we are doing with the Sharpe Ratio in the second screen is to make sure that we do not overlook any fund that might be "better" than the originally selected fund in either of two ways: · *more* risky but having earned a higher return · *less* risky and settled for a lower rate of return Either way, such a fund, as revealed by its Sharpe Ratio, would have shown that it earned more return for the level of risk taken than the fund selected by the original screen and thus achieved a "better bang for the buck." Even though very few funds pass muster on the second screen, which is run separately for 3, 5 and 10 years as the available data allows, such funds fall into the more extreme groupings of risk and return and have to be subjected to further, very careful analysis. We repeat. In search for *performance*, as we have chosen to define it, we are not looking for mutual funds with "hot hands" that are currently riding a winning streak. We are not trying to find "winners" in the conventional sense. What we are looking for, and firmly believe we can and have found, are those mutual fund managers who have consistently demonstrated that they do a better job than their peers in "getting what they paid for," by earning more return for the degree of risk they undertook. That kind of a result, unlike the more popular notion of "performance", is capable of being repeated over and over again by the mutual fund managers who achieve it. Unlike the typical "hot hands" manager, who is usually the most surprised of all by what he has just done, the kind of mutual fund manager we seek and find knows exactly what he is doing and how to continue doing it. Again, risk adjusted performance is strictly relative. As a consequence, our fund managers almost always have their "cold spells," periods of sub-par performance in the conventional sense as measured solely by absolute rates of return. Even so, with those managers you can be confident, in good times and bad, of being well paid for the risk you have taken. That is what we mean by "good investment performance."



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