

## The Impact of Strategy on Performance

*“The stock market is cyclical and no strategy is in favor 100% of the time.”*

From the years 2000 to 2006, a mutual fund named Growth Fund of America outperformed its average Large Growth stock peer by a significant margin. This, combined with the fact that several share classes of the fund pay commissions to brokers, resulted in the fund’s quick ascension to the top of the mutual fund industry’s asset list. *Fund assets grew from \$27 billion at the beginning of 2000 to approximately \$200 billion at its peak late in 2007.*

Unfortunately, a market shift in 2007 changed the short-term fate of Growth Fund of America and the fund has since underperformed. The impact on assets has been fairly significant as fickle investors with short-term mindsets are selling the fund in pursuit of a stronger *recent* performer. What they have failed to realize is they are selling a fund that overall is a fundamentally strong long-term option with an out of favor strategy.

Investors who own multiple stock funds may lack a true understanding of the strategies employed by their fund management teams. Without this understanding, they often react to sub-par short-term results by replacing funds at less than favorable times, such as periods where performance has been impaired by an out of favor strategy that may soon return to favor.

The long-term impact of poorly timed investment shifts can be significant. When considering the purchase or sale of a fund, investors should make sure they understand the strategy employed by the management team and how it may impact performance. The stock market is cyclical and no strategy is in favor 100% of the time. When under-performance occurs, it is helpful to determine whether the cause is an out of favor strategy or mistakes made by the management team. For the top mutual fund teams in the industry, we can state without hesitation that the vast majority of underperformance is caused by an out of favor strategy rather than mistakes.

Mutual fund strategies come in all shapes and sizes. Some are more flexible, such as “opportunistically investing in stocks to increase long-term shareholder value.” Others are more specific and define the investment style (growth, value, blend), capitalization range (small, mid, large), diversification requirements (holding and sector) and preferences of the management team (e.g. high quality, dividend paying, etc.).

Another important consideration when monitoring fund management teams is how much leeway their strategies allow. Teams with flexible strategies and relaxed diversification mandates often invest in a more opportunistic manner by making more sizeable bets in individual holdings or sectors. This can result in increased long-term returns if the team has talent, but investors who choose these types of fund managers also need to recognize that holdings and sector bets result in more management risk. In other words, if they get it wrong, watch out! Funds managed by teams with more flexible strategies are typically more volatile and thus require more patience on the part of investors.

In recent newsletters, we have stressed the impact of asset allocation on returns. The same holds true for fund management teams where the vast majority of return deviation from their peers (similar funds) will be determined by the market cap range, investment style (growth, value, blend)



and sector allocations. To determine or monitor a team’s market cap and style preferences, Morningstar creates an ownership zone for each fund, which is available on their website, [www.morningstar.com](http://www.morningstar.com). The ownership zone is a representation of a team’s current positioning and it is one of the more telling pieces of information available on Morningstar’s website.

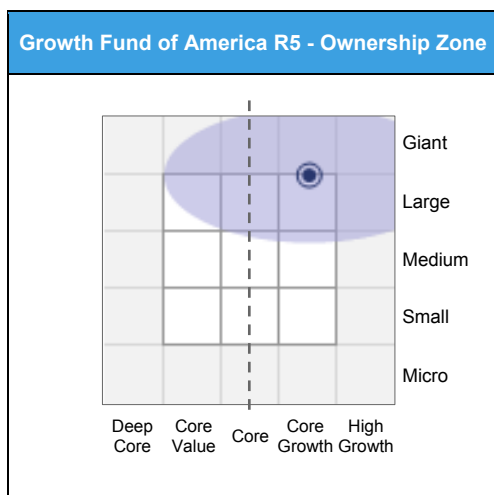
The strategy employed by the team that manages Growth Fund of America is what industry insiders call a “GARP” strategy, or “Growth At a Reasonable Price.” In other words, the strategy is growth focused, but the team keeps an eye on valuation. This results in a “value leaning” ownership zone (when compared to other Large Growth funds) with above average exposure to value stocks and sectors that are traditionally labeled value sectors. *The ownership zone for Growth Fund of America can be found in Table 1 on page 2.*

The fund’s broad ownership zone serves as a headwind when growth stocks outperform value stocks, but the opposite is true when value outperforms growth. Guess what happened in the fall of 2007? After a six-plus year period where value outperformed growth by a significant margin, a major shift occurred in the market and growth reassumed the leadership position. This quickly ended Growth Fund’s winning streak versus its peer group, and we were not surprised or concerned because we understand the strategy and how it can impact performance.

For comparison purposes, let’s look at another solid long-term Large Growth performer, Harbor Capital Appreciation. The team that manages Harbor Capital Appreciation employs a pure growth strategy. In other words, they are willing to pay full price for a company they believe will grow at an above average pace. Exposure to traditional value sectors is limited and the fund routinely has more price risk than Growth Fund of America (*i.e.* the ownership zone is more tightly confined to the growth side of the market). *The ownership zone for Harbor Capital Appreciation can be found in Table 2.*

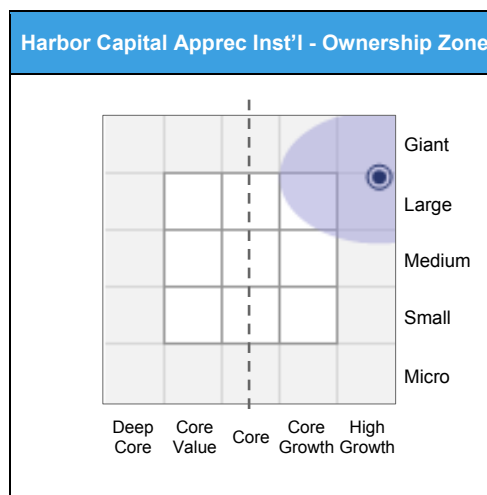
If you had any doubt that fund strategies and their resulting portfolio allocations have an impact on performance, the information in *Table 3* on page 3 should remove that doubt. In this table, we have summarized the performance of the Large Growth peer group, the Large Value peer group, Growth Fund of America R5, and Harbor Capital Appreciation Institutional across three performance periods: 1) 1995 to 1999 when growth stocks outperformed value stocks, 2) 2000 to 2006 when value outperformed growth, and 3) 2007 through June 30, 2011 when growth has outperformed value. We believe the results speak for themselves.

**Table 1**



Source: [www.morningstar.com](http://www.morningstar.com)

**Table 2**



**Table 3**

Market Period Performance				
Morningstar Category	1995 to 1999	2000 to 2006	2007 to June 30, 2011	1995 to June 30, 2011
Large Value	140.9%	50.9%	-5.3%	244.2%
Large Growth	268.1%	-22.0%	10.3%	216.6%

Fund	1995 to 1999	2000 to 2006	2007 to June 30, 2011	1995 to June 30, 2011
Growth Fund of America R5	262.9%	40.4%	8.2%	451.6%*
Harbor Capital Apprec Inst'l	333.1%	-21.3%	21.2%	313.2%*

**\*Special note regarding Growth Fund of America and Harbor Capital Appreciation**

The funds mentioned in this newsletter were used to illustrate the impact of strategy on performance and the content should in no way be interpreted as a recommendation to buy or sell Growth Fund of America or Harbor Capital Appreciation. For those comparing the two funds, it is important to recognize that both are solid long-term options and the fund that is optimal would be determined by how it complements the other funds used in the portfolio.

In addition, there are factors to consider beyond performance when investing in a fund. The optimal choice is not always the fund with the strongest historical results. In this case, Growth Fund's results were aided by an extended period of value outperformance, but overall, these funds are comparable given their fundamental strength.

Source: Morningstar Principia, 06-30-2011 release

**Conclusion**

Years ago, the market was driven by fundamentals in the short-term more than momentum, a fact that may no longer be the case. In addition, market shifts were less significant in magnitude and duration. Today, performance runs are exaggerated by a lack of investor understanding and reduced trading barriers (often resulting in bubbles), and fund management teams are finding their strategies out of favor for longer periods of time with more pronounced degrees of underperformance. There is more management risk today than there was twenty years ago.

For this reason, it is increasingly important to understand the strategies used in the mutual funds you own. It is also important to obtain strategy or management diversification by selecting teams that have different areas of focus (*i.e.* domestic/foreign, large/mid/small, growth/value/blend, defensive/speculative, dividend/non-dividend, etc.).

Picking from a pool of the top mutual fund managers does not guarantee success. If investors consistently chase the strongest recent performers within the pool, they may end up with funds that have similar strategies and may buy those funds toward the end of a period in which their strategies have been in favor. An effectively diversified portfolio with high quality management teams that complement each other will have less deviation from portfolio benchmarks and the odds of consistently beating benchmarks will increase – a goal of every investor.

**Market Comments**

Market eyes are focused on mixed economic results, the end of the Fed's latest quantitative easing program, and domestic and global debt concerns that are increasingly making it difficult for policy



makers to add stimulus. Putting this all into perspective is very difficult given the number of variables, but here is our take...

After a multi-decade period of declining interest rates that resulted in lower savings rates, lower borrowing costs, increased consumption (demand for goods and services), and higher asset prices (fueled by increased consumption), asset prices reached a point where they surpassed affordability. We were living in an artificial world where asset price escalation created a wealth effect, and unfortunately many people simply borrowed from their increased home values or spent their stock market gains to promote the lifestyle their incomes alone could not support.

As the consumption bubble burst and the cascading effect began in the financial markets, global policy makers attempted to chop off the bottom of the “V” with stimulus. Think of being on one side of a canyon with the need to get to the other side at some point in the future. After starting down, you get tired and explore your options – 1) endure the painful trek down through the valley and up the other side or 2) build a bridge. The goal of global policy makers by adding stimulus is to build a bridge, thus avoiding the pain of the valley. However, if it were that easy and certain, investors would be less nervous.

History suggests that larger asset bubbles result in wider and deeper canyons. The recent bubble was created over a number of years and the scale was so large historians will study it. Therefore, we can only hope the bridge builders don’t run out of materials (*i.e.* money for stimulus) before the bridge is complete. As of the writing of this commentary, the Fed is no longer increasing the size of its balance sheet (*i.e.* QE2 has ended) and political support for stimulus is lacking due to our debt concerns. However, Ben Bernanke just mentioned in Congressional testimony that the Fed is testing additional stimulus measures in the event that economic conditions deteriorate. In other words, if the Fed determines the bridge has not fully covered the span, they may be forced to keep building.

The concern with current stimulative measures is their unprecedented nature, which creates uncertainty, and the mounting debt left in their wake. In addition, stimulus prevents asset markets from clearing themselves and the lessons that should be learned may not fully be learned due to a prevention of the more painful outcome (*i.e.* the valley). Are global policy makers charting the right course? Only time will tell. There is a chance that historical reflection will result in the belief that their efforts were effective. It is easy to second guess policy makers without the experience of the valley.

Investors should have confidence that this is a canyon, not a cliff. Population growth and an emerging world will spur the global economic growth necessary to ensure that the other side of the canyon does exist and it is higher than the side we are on. In fact, it is likely that our bridge is past the deepest parts of the canyon, so if we are forced to reduce or eliminate stimulus, the private sector is in better shape than it was two years ago. Investors should also keep in mind that the markets are pricing in current concerns, so there is a level of protection in place for a less than perfect outcome. With that said, given the uncertainties that exist, it remains critical that investors strictly follow fundamentals when making investment decisions and avoid the temptation to time the markets.

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