# MV Capital Management E-Update

Of Managers and Markets
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Heading into the fall holiday season we think it is fair to say that – on the surface at least – the markets have given us more treats than tricks so far. As of October 10th the S&P 500 had returned 10.02% year-to-date and most of our asset classes have been humming along in positive territory somewhere north or south of the S&P. The Dow Jones Industrial Average crashed through its previous all-time high of 11,722 on October 3rd and has powered onto new highs on all but one trading day since then, closing at 11,867 on October 10th for a year-to-date gain of 10.73%. As we approach another earnings season where double-digit year-on-year growth is expected for the S&P 500 average, followed by the seasonal uptick for retailers and the usual year-end "window dressing" by portfolio managers, one might argue that we should start filling our cups with Christmas cheer a little on the early side this year.

From a fund manager's perspective, however, the markets resemble nothing as much as – to borrow a phrase from Winston Churchill – a mystery wrapped in a riddle inside an enigma. The number of US equity mutual fund managers who have outperformed their asset class benchmarks in 2006 to date has been strikingly low across all styles and capitalizations. Consider large cap value, a perennial bellwether for asset allocators. We looked at a universe of 722 large cap value funds that have been in operation since at least September 1996. From these 722 funds a total of 102, managed by 25 different fund managers, beat the Russell 1000 Value index on an annual average basis over 1996-2006. Of these 25 managers precisely one – Wells Fargo Advantage – was up versus the Russell 1000 Value thus far in 2006.

In the small cap value space not a single fund manager listed in the Zephyr StyleAdvisor database has outperformed the Russell 2000 Value index this year (using the same criteria of funds with a 1996 or earlier inception date that beat the benchmark over the 1996-2006 period on an annual average basis). The numbers were somewhat higher for large and small cap growth. 40 out of the 174 managers that beat the Russell 1000 Growth index over ten years have outperformed so far this year, while 10 out of 31 small cap growth managers have done likewise against their benchmark Russell 2000 Growth index.

Why the paucity of superstars this year? The managers all have their rationales, but the most plausible one to us is that, quite simply, many of the stocks which have been leading overall performance have been among the weakest in fundamentals. Managers call this an inversion. Typically portfolio managers conduct a quantitative screening of stocks at the outset of their selection process and use fundamental data points such as price-earnings, price-book, return on equity, growth forecasts and debt-equity ratios to get from a universe of several thousand stocks to the 30-50 or so that make up the portfolios. In conducting our own due diligence on managers we have noticed a consistent theme – that these stocks with superior fundamental characteristics have significantly underperformed the overall market year-to-date.

Why does this happen? After all, isn't diligent fundamental analysis in the mode of Benjamin Graham and Warren Buffett the key to long-term investment success? Ah, but the road to long-term success is also paved with the bumps and ruts of short-term anomalies, irrationalities and the madding of crowds. We have every reason to believe that a disciplined manager with a track-record of consistent outperformance over a suitably long time period can continue to deliver results (unless something we uncover in our due diligence provides clear evidence otherwise). We also have every reason to expect that these managers will, from time to time, fall into periods of underperformance.

The data support this point. According to a recent study conducted by Litman Gregory, a financial market research company, from a universe of funds that outperformed their benchmarks over a ten year period through year-end 2005 *fully 64% of all large cap value funds and 68% of all large cap growth funds endured at least one three-year period during which they underperformed their benchmarks by 5% or more on an annual average basis*. Think about this – the majority of those elite funds that have generated superior long-term value have gone through long periods of significant underperformance.

To where do these findings lead us? Once again to the primacy of asset allocation, the single most important decision we make on behalf of our clients' long-term objectives for success. Anomalies happen in the short term – but the same anomalies don't happen to all assets in all asset classes at the same time. Relatively few domestic equity managers have outperformed their benchmarks this year, but the same is not true of international & emerging market equities or various fixed income classes. Perhaps the reverse will be the case next year. In any event our clients can always be assured that we at MVCM spend a very large number of our waking hours obsessed with how we can construct and maintain optimal diversification for each client's return objectives and risk tolerance. This is our discipline, and it gets us through whatever curve balls the market may throw us in the short term.

With warm personal regards,

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