THE RESEARCH REPORT
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The Value of Consistency

Steven Karsh, Principal, Director - Capital Markets Research
Scott Middleton, Principal, Director - Investment Committee
Amina Adnan, Research Analyst



The first decade of the new millennium was a wild and unpleasant ride for long-term investors. From 2000 to 2009, equity markets around the globe became increasingly volatile. The early part of the decade had calendar year losses in the S&P 500 of 9%, 12%, and 22%, followed by five years of solid gains with annual returns ranging from 5% to 29%. These gains were followed by a steep loss of 37% in 2008 and a large rebound in 2009 of more than 26%. These severe whipsaws have tested even the most resilient investors to stay true to a disciplined investment approach and remain diversified.

Successful long-term investors not only remain disciplined during volatile markets, but they also seek out professional managers to generate returns in excess of their respective indexes and peer groups. Many investors tend to select investment products for their portfolios by searching out the best performing mutual funds over a recent time period. Their hope is that placing money with these top performers will generate continued success. Using such a selection method inevitably places strong emphasis on managers' performance from a particular beginning point to another time, usually in the recent past. This selection process tends to be highly influenced by the particular beginning and ending dates of the performance measurement.

A recent study[1] by Srikant Dash, CFA, at Standard & Poor's examined the merits of selecting managers based on their point-to-point historical performance. S&P analyzed whether top-quartile performing managers for the five-year period ending March 2005 would be able to repeat their success in the following five-year period. The results were sobering: only 18.5% of large cap funds, 12.7% of mid cap funds and 25.0% of small cap funds that had a top-quartile rankings from April 2000 to March 2005 were able to repeat their top-quartile performance from April 2005 to March 2010. Even a random statistical analysis would have anticipated a repeat rate of 25%. In addition, the study discovered that funds which consistently finished in the bottom-quartile of their peer groups had a much higher likelihood of being merged or liquidated. The S&P study brings to mind the phrase, "past performance may not be indicative of future results."

While Innovest believes that prudent selection of investment managers is rooted primarily in a rigorous and thorough due diligence analysis of managers' qualitative aspects (people, investment philosophy and process, firm structure and ownership, etc.), a careful analysis of investment performance is essential to our recommendations. In particular, we believe that analyzing historical performance is most effective when it focuses on how consistently a manager has performed over a variety of time periods, not just a single span of time. To reexamine the merits of this approach, Innovest recently conducted a study measuring the long-term impact of those managers who consistently outperform a small majority of their peers quarter after quarter.

Our study examined two sets of hypothetical managers: those that ranked in the 40th percentile of their peer groups each quarter (slightly above average), and those that ranked in the 60th percentile each quarter (slightly below average). The study was conducted across five types of products: large, mid and small U.S. equities, international stocks, and high-quality fixed income. The return streams were pieced together by linking returns for the 40th percentile managers and for the 60th percentile managers each quarter to build a 10-year track record. Two independent data vendors, Callan Associates and Lipper, were used to construct the peer universes. Callan Associates' universes tend to be more style pure and have fewer constituents. Alternatively, Lipper universes are somewhat less style-pure and encompass more constituents (including multiple share classes for a particular fund). Both sets of data take into account survivorship bias. Although the study's results are not astonishing, they are enlightening. The idea of placing in the 40th percentile each quarter may seem like a plan

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for mediocrity. However, the study showed that consistency had a remarkable impact on long-term performance. Regardless of the style universe or data vendor, each of the five hypothetical managers that modestly outperformed a majority of their peers (40th percentile in each quarter) placed in or close to the top quartile over the entire ten-year period (April 2000 to March 2010). Moreover, these hypothetical managers also beat their benchmark indexes for the entire ten-year period.

Conversely, the hypothetical managers that modestly underperformed a majority of their peers (60th percentile in each quarter) ended up in the bottom quartile for the ten-year period and well below their respective indexes. The results are summarized in the table below:

Consistency Study April 2000 to March 2010				
	40th Percentile Managers Percentile Ranking after 10 Years			
	Callan	+/- Index	Lipper	+/- Index
Domestic Large Cap Equity	24	+2.44%	24	+2.07%
Domestic Mid Cap Equity	28	+0.07%	14	+1.60%
Domestic Small Cap Equity	26	+1.74%	20	+2.42%
International Equity	33	+1.88%	26	+0.55%
Core Fixed Income	34	+0.01%	18	+0.12%
	60th Percentile Managers Percentile Ranking after 10 Years			
Domestic Large Cap Equity	81	-2.95%	82	-1.51%
Domestic Mid Cap Equity	91	-10.13%	72	-4.31%
Domestic Small Cap Equity	83	-8.28%	79	-3.16%
International Equity	86	-2.63%	81	-2.89%
Core Fixed Income	89	-1.47%	80	-1.37%

Indexes used for comparisons: Domestic Large Cap Equity—S&P 500, Domestic Midcap Cap Equity—S&P 400 , Domestic Small Cap Equity—S&P 600, International Equity—MSCI EAFE, and Core Fixed Income—Barclays Capital Aggregate.

Innovest's approach to manager selection and performance analysis is built on the principle of consistency. The two most important screens in our quantitative due diligence of historical performance are the consistency of annual and rolling-three-year period returns. In both screens we examine how many times a manager outperformed both the median manager and their index benchmark. Innovest realizes that it is unrealistic to expect even the best long-term performing investment managers to be in the 40th percentile or better in each calendar quarter and in each three-year period. In fact, many of the best managers have underperformed their peers over one-, two- and three-year stretches of time. However, our study indicates that managers who tend to outperform quarter-to-quarter and year-to-year should generate strong long-term results.

[1]"Does Performance Matter", S&P Indices/Research & Design by Srikant Dash, CFA, FRM.

Steven is a Principal and Director of Innovest's Capital Markets Research. Scott is a Principal and Director of Innovest's Investment Committee. Amina is a Research Analyst at Innovest.

Innovest Portfolio Solutions LLC
4643 South Ulster Street, Suite 1040 ~ Denver, CO 80237
(303) 694-1900 ~ (303) 694-4707 fax ~ www.innovestinc.com