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WEALTH MANAGEMENT

How Investors Can Avoid an Overlooked Pitfall of Investment Management

In "*The Next Chapter in the Active versus Passive Management Debate*," a white paper published in October 2015, DiMeo Schneider & Associates, L.L.C. evaluated the persistency of top quartile mutual funds in 17 categories during the 10-year period ended December 31, 2014.[1]

The results would have been eye opening had it not been for previous research from 2007, 2010 and 2012. Despite the vastly different market environments during the prior periods, our advisement has been consistent.

Some statistics:

- 92 percent: The percentage of top quartile mutual funds unable to avoid the bottom half of their peer groups at least one three-year period between 2005 – 2014.[1]
- 56 percent: The percentage of top quartile mutual funds unable to avoid the bottom half during a five-year period between 2005 – 2014.[1]

When allocating capital to active managers within your investment portfolio, the question is not what to do *IF* your manager underperforms but *WHEN?*

The failure to address this question is key to what John West, CFA at Research Affiliates calls "the biggest failure in investment management", the negative gap between fund total returns and investor returns.[2]

Morningstar defines investor returns as the measurement of how the average investor faired in a fund over a period of time. Whereas total return measures the compounded growth rate for an investment over the same period, investor return is calculated by taking into account the impact of cash inflows and outflows (purchases and sales) into and out of the fund in addition to the growth of fund assets.

A side-by-side comparison of Total Return versus Investor Return, for a sample of actively managed mutual funds, illustrates this often-overlooked phenomena:

		Total Return	Investor Return
US LCC Active Manager	10-Year Annualized Return	13.86%	10.82%
	10-Year Peer Group Rank (%)	7	64
		Total Return	Investor Return
Intl DM Active Manager	10-Year Annualized Return	8.82%	3.46%
	10-Year Peer Group Rank (%)	17	87
		Total Return	Investor Return
Intl EM Active Manager	10-Year Annualized Return	8.77%	2.92%
	10-Year Peer Group Rank (%)	18	73

SOURCE: Morningstar return data as of 12/31/2018

Put into practical terms, let's looks at the impact of this negative return gap on a $500,000 investment in the International Developed Market Active Managers highlighted above.

		Beg. Value	Time Period	End Value
Intl DM Active Manager	Total Return	$500,000	01/01/09 - 12/31/18	$1,164,279
	Investor Return	$500,000	01/01/09 - 12/31/18	$702,578

SOURCE: Values based on Morningstar return data as of 12/31/2018

The result of our past active versus passive research, along with this negative return gap data, shows due diligence is not just a necessity when it comes to determining the effectiveness of active versus passive managers (within specific asset classes). However, investors must have a thorough and duplicative process allowing them to know upfront a manager's investment philosophy, process and sub-style.[1]

Although the exercise requires significant oversight, resources and a sound overall strategy, the result is the ability to invest with confidence and the patience necessary to achieve long-term success. If this exercise is omitted, succumbing to the inclination to buy the winner and sell the loser is significantly increased.

Based on the above return metrics, we see average investors' decisions regarding the appropriate time to buy and sell could not only result in lower portfolio returns but may eliminate the opportunity to experience excess returns (or alpha) through active management. Unfortunately, making the wrong choice at the wrong time, investors increase the likelihood their portfolios will not generate the returns needed to achieve their long-term financial objectives.

[1] The Next Chapter in the Active vs. Passive Debate by Anthony Novara, CFA, Bradford Long, CFA and Matthew Rice, CFA, October 2015

[2] The Biggest Failure in Investment Management: How Smart Beta Can Make It Better or Worse by John West, CFA and Jason Hsu, PhD, October 2018