The Predictable Demise of a Rock Star Mutual Fund Manager

It is perfectly understandable if you have never heard of Bill Miller. Most finance wonks know that Bill Miller is one of the most closely watched money managers in the industry, so it was supposed to be big news when he announced his decision last week to step down as portfolio manager of Legg Mason Capital Management Value Trust early next year. For us, his departure adds another predictable chapter to the long-running debate regarding the futility of active stock selection.

While we won't pity a fantastically wealthy man like Bill Miller, it's hard to imagine what it might feel like to go from seeing yourself on lots of professionally airbrushed cover pages and worshipped by a cult-like following to suddenly finding yourself in less-than-flattering poses on dozens of blogs that openly question your intellect.

Miller's most-lauded triumph is the fifteen-year period from 1991 through 2005, during which his fund, Value Trust, outperformed the S&P 500 each calendar year, catapulting him into Rock Star Fund Manager status. His success attracted an extensive and fervent following: Morningstar named him Portfolio Manager of the Decade in 1999, Barron's included him in its All-Century Investment Team that same year, and a Fortune profile in 2006 described him as "one of the greatest investors of our time."

In a startling inflection, his departure comes after a long decline in which his performance trailed that of the S&P 500 – quite badly – for four of the past five years. Value Trust shrank from $21 billion in assets in 2007 to $2.8 billion as of December 2011.

Also predictably, if you really analyze the data through a scientific lens, you'll find that Legg Mason Value Trust is a large cap value fund and has underperformed its true benchmark over time.

Over the May 1982–October 2011 period, the annualized returns were 11.28% for the S&P 500 Index and 11.76% for the Russell 1000 Value Index. Value Trust slightly outperformed the S&P 500 Index and underperformed its real index, the Russell 1000 Value, by over 0.40% per year. A statistical three-factor regression analysis over the same period shows the fund underperformed its benchmark by 0.08% per month.

Miller's bold and quite concentrated investment style helped create showy returns in some years. Unfortunately, his more recent big bets revealed the dangers of a concentrated strategy as heavy losses in stocks such as Bear Stearns and Eastman Kodak crippled his fund. For the five-year period ending December 31, 2010, his fund finished dead last among 1,187 US large cap equity funds tracked by Morningstar. **By the way, it is *incredibly difficult* to finish dead last out of 1,187 funds.**

Considering the enormous variation in his returns, depending on the time period selected, Miller's overall investment record presents an interesting conundrum: How can we decipher the apparent contribution of good luck or bad luck, of skill or lack of skill?

What we really like about Miller is that he is well aware of the challenge of distinguishing luck from skill and has conspicuously declined to brag about his results, even when they were uncommonly prolific. He has acknowledged that topping the S&P 500 each year for fifteen years was an accident of the calendar and that using other twelve-month periods produced a less headline-worthy result.

Do his results offer conclusive evidence of the failure of active management? Not necessarily, but they certainly shed some light on the mutual fund industry. If you can advertise above-market returns, you can charge a lot for your fund. His fund's annual expenses are ruinously costly at over 1.75%, which provides a high hurdle for any stock picker to overcome. If you ignore the fund fees, the fund's performance versus its benchmark goes from -0.08% to 0.07% per month.

This swing from negative to positive raises an interesting point of which the academic and scientific community is well aware. There may be some inefficiency in market prices and almost certainly some skillful managers who can exploit them. But who is likely to get the benefit of this knowledge – the investor with his capital or the clever money manager? If stock-picking talent is the scarce

resource, economic theory suggests the lion's share of benefits will accrue to the provider of the scarce resource – just what we see in the saga of Bill Miller.

The ever-present commentators have said that Miller has "lost his touch" or that his investment style is no longer suitable in the current market environment. Neither of these arguments is particularly cogent. In fact, they present the uninformed retreat of those who just cannot seem to grasp that market prices are fair enough that even the smartest students of the market cannot identify mispriced securities.

In the end, hiring active fund managers is neither worth the risk nor the expense. The time required to distinguish luck from skill is usually measured in multiple decades and often far exceeds the span of an entire investment career. Our investment horizons are inevitably longer than the lucky streaks of every Rock Star Manager – past, present, and future.

Crisis, You Say? Great News!

These days, whenever someone casually finds out what we do for a living, the very next words out of the person's mouth are routinely some version of "What do you think about the crisis? Are your clients upset/ stuffing money under the mattress/jumping off a bridge because of what is happening in Europe?"

It would be inappropriate at that moment to launch into a passionate lecture about the nature of capital markets, risk-controlled portfolios, behavioral finance, and a gazillion other concepts they need to know so they don't fritter away their kids' inheritances (if their money lasts that long).

We usually just offer a polite and succinct reply that our clients are quite savvy and recognize that all known information and the current sentiment of all investors are already "baked in" to the current market prices. If the crisis turns out to be worse than current sentiment reflects, we'll buy more equities at lower prices. If the crisis turns out to be milder than the market estimated, we'll be taking profits after securities rise in value.

It's generally at that moment when we wish we carried the graphic below[1] in our back pocket so we could graciously hand it to the anxious armchair investor who is interrogating us and then perhaps courteously change the subject to something not work related.

We think the public's anxiety about what happens to portfolio returns following a crisis is brought about by horror stories from poorly designed portfolios that failed to survive the S&L crash, dot-com bubble, credit crunch, or similar market event.

Balanced portfolios that are globally diverse and are stabilized by the presence of high-quality short-term bonds are incredibly resilient in even the most over-hyped crisis. Well-designed portfolios recover from market downturns, while concentrated portfolios with too few holdings may not.

Owners of balanced portfolios know that there will always be crises and that, as long as they don't pretend otherwise, they will patiently achieve their investment goals while others obsess over the next crisis.

[1]The information below shows the composition of the concept demonstration portfolio we used for the 60/40 balanced strategy graphic on the previous page:

Balanced Strategy: 7.5% each S&P 500 Index, CRSP 6-10 Index, US Small Value Index, US Large Value Index; 15% each International Value Index, International Small Index; 40% BofA Merrill Lynch One-Year US Treasury Note Index. The S&P data are provided by Standard & Poor's Index Services Group. International Value Index provided by Fama/French for July 1981–December 2010 and MSCI World ex USA Value for January 2011–September 2011. *Any performance data represents past performance. Past performance is no guarantee of future results, and current performance may be higher or lower than the performance displayed. The investment return and principal value of an investment will fluctuate such that an investor's shares may be worth more or less than their original cost.*

The Trustee Dilemma

At times a necessary evil, a trust is an effective tool for dedicating resources to support your spouse, your children, and generations that follow. Creating a trust may even be required to help manage taxes. However, selecting the right trustee is a tough decision for many and one that will impact the success of your plans and the happiness of your beneficiaries. It is difficult to find a trustee with the desired qualities of honesty, stability, dependability, organization, financial experience, and ability to devote time and energy on an impartial basis for the benefit of all beneficiaries.

In our experience, there is no one-size-fits-all solution to the trustee selection dilemma, as every family has its own set of complexities and idiosyncratic personalities. Generally speaking, trust documents will name either family members or a trust company as the trustee. There are significant pros and cons to each path that require further consideration.

The risk in naming a family member or close friend can materialize when intra-family conflict is an issue. Even when no such conflicts exist, we have seen trusts poorly managed by well-intentioned family members. Individuals acting in this capacity are not held to the same professional fiduciary standards as a corporation. Your beneficiaries generally have very little recourse in the face of poor trust administration other than to hold the family trustee personally responsible. Suing Uncle Roger because the hot stock tip he got from his broker bankrupted little Susie's trust is sure to dampen the mood on Thanksgiving.

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Trust companies will tell you that they have the advantage of being very well regulated and that, as professionals, they are held to a much higher standard. The issue with trust companies is that they have been plagued by conflicts of interest, poor investment performance, high staff turnover, and rampant mergers within the industry. There is also an inherent conflict if the trustee is also the investment manager. How objective will the bank really be in reviewing its investment performance? In our experience from working with numerous trust beneficiaries, we have never seen corporate trustees fire themselves due to poor portfolio management!

Another issue with trust companies is that the people you knew and trusted at the company may be long gone by the time they need to serve as trustee. You may find that these trusts are now being administered by some department of a big bank three time zones away that is terribly unresponsive to your beneficiaries. Their 1-800 number is simply not going to be comforting to a bereaved widow or college student.

There certainly could be situations when you may need to appoint a trust company as trustee, but you should have clear, compelling reasons to do so. The ugly side of the business is that too often we have seen brokers and bankers work to irrevocably appoint their firms to the trustee or investment management positions when the need for a trust in the first place was dubious at best. This conflict is generally facilitated by an attorney with more loyalties to his or her referral source than to the client. Your beneficiaries are the ones who will suffer. How responsive do you think a company will be when they know that it is extremely difficult to fire them?

We have firsthand experience with how hard it can be to remove an entrenched corporate trustee. On behalf of several of our clients, we have requested the resignation of different trust companies due to performance and service issues. Their refusal then requires legal action and court involvement to remedy the problem.

We strongly recommend that if you are appointing a trust company to serve as your trustee, give due consideration to providing your beneficiaries the power to replace the trustee. You will find the trust company to be significantly more responsive to your beneficiaries if they can be fired. If needed, you could also appoint a family member as co-trustee along with the trust company and give that individual the power to replace the corporate trustee.

The good news for investors and beneficiaries alike is that the trust industry continues to evolve. Advancements by service providers can allow a family member who is serving as a trustee to access an entire menu of trustee support services on an à la carte basis without a conflict of interest.

Rockwood works with a number of companies that have made it a priority to provide these fiduciary services on an as-needed basis. These firms can serve as the custodians and provide as much (or as little) support as an individual would need while fulfilling his or her administrative, reporting, and fiduciary responsibilities.

Companies such as Fidelity and Schwab have even established trust accounting platforms that are very reasonably priced and are integrated into the same systems we use for portfolio management, making it a seamless process for trustees. This arrangement provides an environment where trusted friends and family can protect the beneficiaries while still providing professional administration.

We are certainly not a trust company, nor do we wish to be, as in our view that would present a conflict of interest. We've worked diligently to formalize and develop systems to support our clients, no matter whom they would like to appoint as trustee – or even if they have been asked to serve in such a role themselves. Feel free to reach out to us; we will happily walk you through what is best for you and your beneficiaries.

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