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*2011 Informational Series of Common Client Questions and Investor Education*

# Index[1] Fund (Passive) Investing vs. Analysts' (Active)Stock Selections

The Value of "Brains" Behind Selections Broke Down in the Panic Markets 2007-2009,
But Remains Important for Long-Term Investing

Identifying skilled managers/analyst teams who are most likely to beat their benchmarks on a risk-adjusted basis is far more complicated than just chasing past returns.

## Summary – Risk/Reward Measurements of Portfolio Selections

"Alpha, higher-than-expected historical returns generated by an investment strategy, is often considered the holy grail of the investment world. Achieve alpha, and you've beaten the market on a risk-adjusted basis. It is the return in excess of the compensation for the risk borne, and thus commonly used to assess active managers' performance." [2] It is also related to "Beta," which is the risk taken compared to an index or category.

During the panic-driven markets of 2007-2009 these tools broke down. We had a wild "momentum-driven" market based on emotional fear of a Depression. Today, fundamental analysis, Alpha, Beta, Morningstar risk/reward rankings, Sharpe ratio and other mathematical models all seem important again - as they have been historically. Overall these are called "***quantitative strategies***" - vs. index funds or ETFs.

Studies have tested whether past performance has been predictive of future results of managers. While past performance does not *assure* future results, it can help in making investment choices, along with evaluation of other factors which I use in making recommendations.

I have prepared a separate report on past performance, detailing research on when and how it has been relevant historically as a tool in selecting potential future opportunities.

## Detailed Analysis

*Alpha* measures the underperformace or outperformance of managers in their stock selections for the risk taken (Beta) vs. an index or category/sector.

A pure index fund or ETF would have a Beta (risk) of 1.00 relative to the index and a small negative Alpha by the amount of the expense ratio/asset management fee. Positive Alpha is a measure of by how much a manager or portfolio exceeded the expected return based on the risk taken (Beta).

Morningstar has a "star" system[3] that mathematically evaluates and ranks risk vs. reward using a different formula. An independent study said, "The evidence suggests that the better performance of the higher star categories reflects superior stock selection rather than market timing abilities."[4] There are other factors in my recommendations other than just Morningstar ratings, but they can confirm other considerations.

The Morningstar ranking is a refinement of the Sharpe ratio and its variation, the Sortino ratio, which removes the effects of upward price movements on standard deviation to measure only return against downward price volatility.

### Recent Panic Market vs. Historical Risk/Reward Correlations

J.P Morgan and others have pointed out that in the panic, depression-fearing markets of 2007-2009 there was high correlation of most stocks, where markets moved up and down with little regard for company selection or quantitative strategies. There was more momentum investing or "following the herd" vs. looking at company valuations or outlooks.

For the most part, individual company selection remains important. Usually it is worth paying human analysts to make selections based on quantitative strategies and a history of positive Alpha performance.

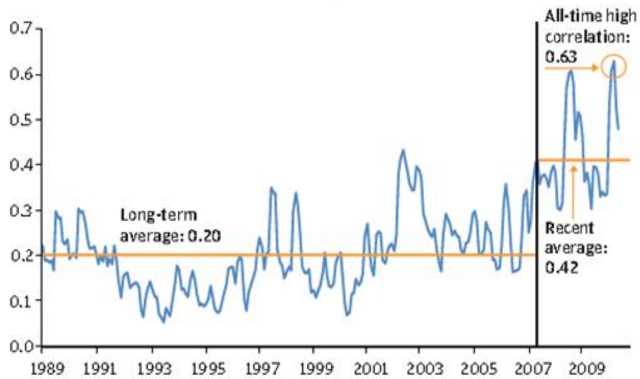
***Re-QUANT-ifying Your Portfolio*** - Highlights of March 2011 JP Morgan Report

Quantitative strategies did not escape the pummeling experienced by most asset classes as the credit crisis unfolded. In August 2007 leveraged quantitative hedge funds collapsed, facing both margin calls and investor redemptions, causing a domino effect and a massive sell-off which disproportionately impacted performance of quantitative strategies.

In Q1 2009 valuation spreads widened to historical peaks. In the midst of the ensuing market mayhem, investors assumed a more risk-averse posture, favoring high quality, defensive stocks and shunning those that appeared "cheap"…and might become cheaper.

No time for stock picking: Correlations have spiked

EXHIBIT 1: PAIRWISE CORRELATIONS, U.S. LARGE CAP STOCKS




Source: J.P. Morgan, September 30, 2010.

Finally, once it appeared that financial and policy initiatives might have succeeded in pulling markets back from the brink, return-starved investors began to favor valuation opportunities versus more defensive stocks. Momentum factors seemed to have shifted into reverse, with the lowest ranked stocks outperforming the highest ranked. The magnitude of momentums swings hadn't been seen since the Great Depression.

Now that the financial crisis has begun to ebb and markets are normalizing, the value of quantitative strategies is important again for alpha generation (excess returns for risk taken).

Hedge funds are not as leveraged now, and the "Volker Rule" on proprietary trading lessens the number of players using quantitative strategies. There is more index and ETF investing, providing opportunities for those using quantitative strategies to outperform those just using indexes or ETF's.

The JP Morgan extensive article with lots of charts and graphs concludes, "Of course, current geopolitical unrest in the Middle East and North Africa, repercussions from the tragic events in Japan, continued distress among the euro zone's peripheral economies and concerns over inflationary pressures in the emerging markets could elevate market volatility levels. However, as we continue to emerge from the dramatically volatile environment of the credit crisis to one of relatively subdued volatility, more normal value spreads and fewer quantitative assets chasing alpha-generating opportunities, we believe this may be an opportune time to revisit these alpha-diversifying strategies and consider their potential for enhancing returns and improving portfolio diversification."

## If you want to be your own stock picker

To take advantage of quantitative strategy opportunities I suggest you need to spend nearly full time researching and learning the techniques. A starting point I recommend is the highly respected book by Richard Tortoreillo of Standard and Poor's, "*Quantitative Strategies for Achieving Alpha*:" [2] The 480-page starter book with back testing of suggested methods is available for a hefty $295 on Amazon.com. For meaningful diversification you also need a sizeable investment portfolio, since you are buying individual stocks, trading them as conditions warrant, and need to be doing ongoing monitoring of all the individual companies.

If you don't want to become an investing expert, I suggest using professional managers with track records of excess returns for the risk taken recommended and monitored by someone that knows these concepts. These are the concepts and strategies that I use given my 25+ years of experience coming from a CPA firm background.



[1]Investors cannot directly invest in indices.

Past performance does not guarantee future results.

[2] Quantitative Strategies for Achieving Alpha (McGraw-Hill Finance & Investing) (2008-11-21) | ISBN-10: 0071549846

[3]The Morningstar Rating, commonly called the "star rating," brings both performance and risk together into one evaluation. Morningstar adjusts for risk by calculating a risk penalty based on "expected utility theory," a commonly used method of economic analysis. Although the math is complex, the basic concept assumes that investors are more concerned about a possible poor outcome than an unexpectedly good outcome and that those investors are willing to give up a small portion of an investment's expected return in exchange for greater certainty.

4 Antypas, Antonios, Caporale, Guglielmo Maria, Kourogenis, Nikolaos and Pittis, Market Timing and the Morningstar Star-Rating System CESifo Working Paper Series No. 2580)