



Back to Earth

– Why not return to a traditional approach to investing?

April 2010

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ACTIVE MANAGEMENT

“There is no way to succeed in active management if you try to control for benchmark risk. You must be willing to deviate from the benchmark if you want to earn returns commensurate with the risk of owning equities. And you must be patient.”

David Swensen
(CIO of Yale Endowment)

A MYOPIC CONDITION

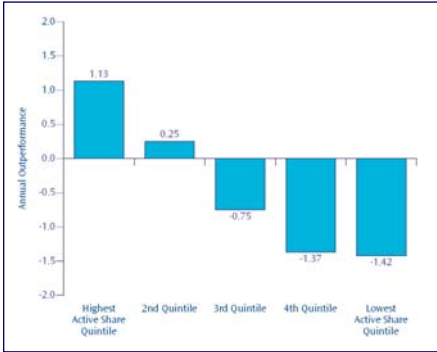
- Majority of active managers underperform
- The problem is the strategies employed by most active managers
- Most active managers are **not** prepared to be different

HIGH ACTIVE SHARE

- **Cremers & Petajisto, 2006 – How Active is Your Fund Manager**
- **Active Share measures the overlap between a portfolio and the index**
 - 100% Active Share implies zero overlap with the benchmark
 - Index funds have 0% Active Share
- **Cremers & Petajisto found that:**
 - Active share is a good predictor of performance
 - Active share has been falling since mid 1980s
 - Most active managers are closet-indexing

HIGH ACTIVE SHARE

Outperformance Sorted by Quintile of Active Share
(US All-Equity Mutual Funds 1990 – 2003)

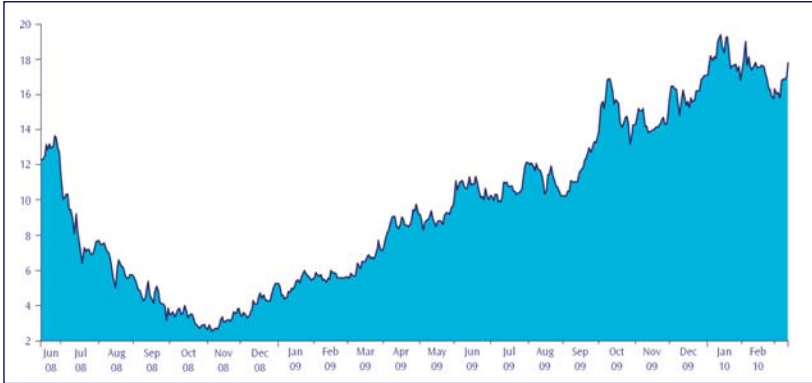


- High active share is a good predictor of outperformance

Source: Cremers and Petajisto

VOLATILITY IS NOT RISK

OGX Share Price (June 2008 to March 2010)



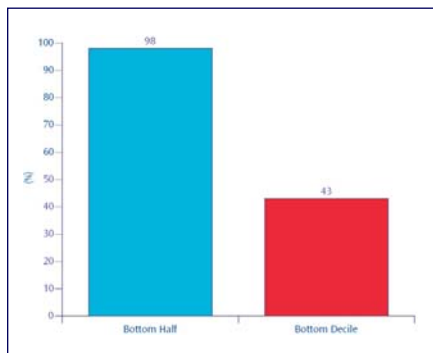
Source: Thomson Reuters Datastream

INVESTMENT ISN'T PHYSICS

- Volatility equals opportunity
- “Buy low and sell high”
- Uncertainty is not quantifiable

CAREER RISK

Percentage of top quartile large cap equity managers whose performance fell into the bottom half or decile for at least one three year period



Source: Davis Advisors: 160 managers from eVestment Alliance's large cap universe whose 10 year average annualized performance ranked in the top quartile from 1st January 1998 – 31st December 2007. Past performance is not a guarantee of future results.

DIVERSIFICATION AS A MEASURE OF RISK

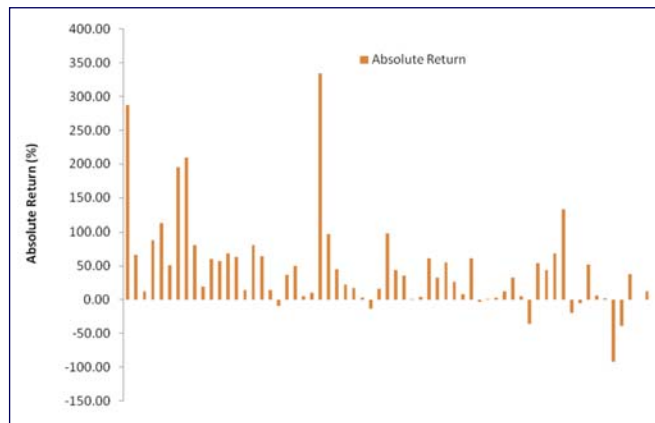
$$N_{\text{eff}} = \frac{1}{\sum_{i=1}^N w_i^2}$$

Where w_i is the weight of the i th asset such that:

$$\sum_{i=1}^N w_i = 1$$

ASYMMETRY OF RETURNS

Performance of holdings in one of our portfolios in 2009



Source: Baillie Gifford/StatPro (calendar year 2009)

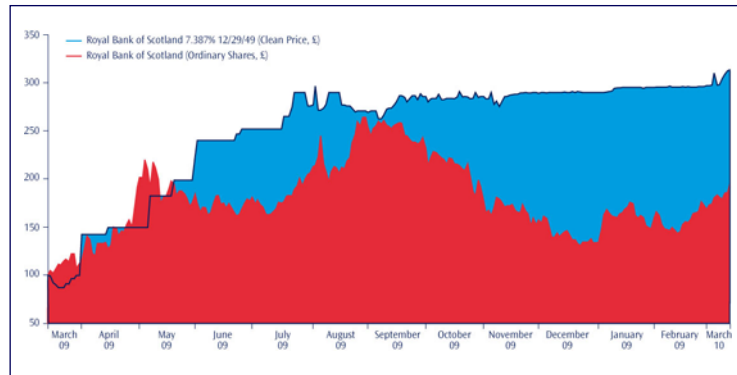
MAXIMISING THE PROBABILITY OF BIG WINNERS

- Is concentration really the way to go?
- Nick 'the Greek' Dandolo and optimum strategies
- Concentrated portfolios maximise the probability of outperformance in the absence of skill

CONCLUSIONS

- If you want to get the best from your active managers, allow them to be active!
- Sack them if they aren't, rather than for underperformance

EXAMPLE: WHERE DO YOU WANT TO BE IN THE CAPITAL STRUCTURE?



Source: Thomson Reuters Datastream

Thank you