BEYOND THE NUMBERS: GETTING TO KNOW A MANAGER

By Maria Crawford Scott

At some point you have to look beyond the performance statistics to see who made them happen, so you can form some kind of judgment about future performance.

Performance statistics are probably the single most scrutinized feature of any stock mutual fund.

These figures are, of course, important indicators of how well a portfolio manager has performed in the past. As such, they can serve as useful flags of a possibly good manager or a possibly bad manager.

But the question facing any prospective investor is: Will a stock fund manager with good past performance be able to sustain his track record?

Good past performance can be the result of sheer luck, or it can be due to a well-thought-out approach that is consistently applied. If it was due to luck, chances are the good performance will not continue. But if the performance was due to a consistent approach, there is at least the possibility of good performance continuing.

That means that at some point you have to look beyond the statistics to see who made the performance happen, so you can form a judgment about future performance. You need to examine a fund manager's approach.

A GOOD APPROACH

A consistent, well-thought-out investment approach cannot be detected by simply looking at a box that indicates the "style" or "size" in which the manager is operating. A good approach consists of an investment philosophy and a selection process that follows from the investment philosophy and is consistently applied.

An index fund has no active manager—its approach consists simply of buying and holding "the market" and providing a "market" return. To justify an active management fee, a fund manager needs to add value to a passive portfolio. So, a "style" or "approach" is the plan a manager intends to use to "beat the market," whether the market is the S&P 500, or some other market segment in which the manager intends to invest. It is also the plan a manager intends to use to beat the competition. The flip side is that an investment approach can be the means by which the market or competition beats the portfolio manager.

If you are investing in an actively managed fund, you need to judge whether the plan makes sense.

Unfortunately, the least visible aspect of a mutual fund is the person responsible for making the decisions. Although the Securities and Exchange Commission requires disclosure of a considerable amount of important material in a mutual fund's prospectus, informative discussions of a fund investment manager's approach are often lacking. In fact, it has only been in the last few years that the SEC has started to require mutual funds to even name the portfolio manager in the mutual fund prospectus.

However, there is material available to individuals—fund marketing literature, manager interviews by the *AAII Journal* (which has published over 130 interviews) and other publications, and even some fund prospectuses—that can help you understand a fund manager's approach, if you know what to look for.

This article focuses on the 10 questions you need to ask about a portfolio

Maria Crawford Scott is editor of the AAII Journal.

manager's approach. Excerpts from past *AAII Journal* interviews of fund managers, most of whom have above-average long-term track records, are used to illustrate what these questions can reveal.

10 QUESTIONS TO ASK

Question No. 1: What is the overall investment philosophy?

Good portfolio managers have philosophies that go beyond a simple statement that they are "value" or "growth" investors. For example, a portfolio manager who really understands and applies a value approach points out that it is one that is going against the market, and that's what creates the "value." In addition, philosophies can sound similar if only a one-word description is provided; big differences emerge when descriptions are more complete.

For example, consider these descriptions by two fund managers, both with good track records and both of whom describe their approaches as value investing.

Harry Hagey, portfolio manager of the Dodge & Cox Stock Fund, described his value approach in a November 1988 *Journal* interview:

"We go through a comprehensive fundamental analysis on individual companies and then compare our forecasts for the prospects of the company against the current pricing. We are trying to find a significant difference between our forecast of future profitability for a company and the profit expectations indicated by the current stock price of that company."

In contrast, Harold Levy, portfolio manager for the First Eagle Fund of America, described his approach in a July 1996 interview:

"We focus on companies that are undergoing some kind of fundamental change, because we think the market does not know how to price "change." If people decided that Coke's growth rate is going from 15% to 16%, all the valuation models in the world will tell you what that would do to the stock's price. But when Allied Signal gets a new chairman, how do you analyze that? It requires a lot more creativity, and that's where we think we can get an edge."

Needless to say, the stock selections of the two funds are quite different.

Question No. 2: What is the stock universe that you select from—for instance, do you focus on dividend-paying stocks, small-cap stocks, mid-cap stocks?

This question zeroes in on the segment of the market in which the portfolio manager is concentrating, which is not always obvious.

The answer to this question should also be tied in with the portfolio manager's investment philosophy. For example, the universe of stocks from which the T. Rowe Price New America Growth Fund makes its selection is the service sector of the S&P 500, which is defined very broadly as non-manufacturing stocks, and consists of close to half of the S&P 500 by market capitalization. In an interview in March 1990, portfolio manager John Laporte explained the rationale for this particular universe:

"The underlying investment thesis is that the service sector of the economy has been the primary engine of growth in the overall economy since World War II, and that this sector of the economy will continue to grow faster than the rest of the economy."

Understanding the fund's universe will also clue you in on the appropriate index by which to compare the portfolio manager's performance. Conversely, an index by which the portfolio manager measures himself may clue you in on the kinds of stocks in which he is invested.

Question No. 3: What is the criteria for initial consideration of a stock? Are screens used to flag potential stocks? Are top-down factors—first focusing on the economy or industry and then looking for the stock—a consideration, or is a bottom-up approach used, focusing exclusively on individual companies?

Funds that use different initial screens will end up with quite different portfolios, even if they share similar philosophies.

For instance, Gary Pilgrim, portfolio manager of the PBHG Growth Fund, is a very growth-oriented, bottom-up fund manager. In an interview in May 1994, he described the screens used by the fund:

"The most important thing we look for is a company whose earnings are currently growing well in excess of 20% per quarter. That's the primary tool. The second derivative is to look for companies that are not only growing rapidly, but appear to be accelerating."

This selection process is a bottom-up approach that singles out growth and, not surprisingly, gives the fund a heavy bias toward technology stocks, a factor that is made quite clear in the fund's prospectus.

In contrast, Ronald Baron, president of the Baron Asset Fund, in an interview in September 1995, described a top-down, value-and-growth approach that selects stocks from what he terms "sunrise industries"—industries that are growing. In other words, first the industry is selected based on growth prospects, and then individual stocks are selected from the industry.

Contrast that with another growth-and-value combination, but this one bottom-up, used by David Schafer, portfolio manager of the Strong Schafer Value Fund. Mr. Schafer described his screens in a January 1994 interview:

"We look for two basic things: The stocks that we will buy must have a price-earnings ratio that is less than that of the S&P 500 and earnings growth prospects over the next several years that are superior to the earnings growth prospects of the S&P 500. What we're trying to do is buy above-average earnings

TABLE 1. BEYOND THE NUMBERS: WHAT YOU NEED TO KNOW ABOUT A STOCK FUND MANAGER

Ten basic questions to ask about a mutual fund portfolio manager to help you better understand his approach.

1) What is the overall investment philosophy?
This should go beyond simple statements such as "the focus is on capital appreciation" or "we seek income and growth." Instead, it should be a basic explanation as to how the manager believes he can make money in the stock market.

2) What is the universe from which stocks are selected?
This question zeroes in on the segment of the market in which the portfolio manager is concentrating, which is not always clear-cut. The answer should be tied in with the portfolio manager's investment philosophy.

3) What are the criteria for initial consideration of a stock; are screens used to flag potential stocks?
Funds that use different initial screens can end up with quite different portfolios, even if their investment philosophies sound similar. In addition, being aware of screens that are used will help potential investors better understand the approach and possible biases of the manager.

4) What "conditioning" or secondary characteristics are examined?
Initial screens may turn up potential winners, but they will also turn up certain kinds of losers. Conditioning screens attempt to weed out the kinds of losers that tend to turn up in the manager's initial screen. Understanding a manager's conditioning screens provides some assurance that the portfolio manager is aware of the potential pitfalls of his approach, and it notifies you of those potential pitfalls, as well.

5) How are stocks valued?
Another very revealing indication of the manager's approach—and it should be consistent with the portfolio manager's investment philosophy.

6) What non-financial characteristics are examined?
Reveals the extent to which the manager examines "qualitative" characteristics, such as corporate management.

7) Is market timing used; by what percentage do cash positions vary?
A red flag question. It is difficult to predict with any accuracy the future direction of the stock market over a short time period. If you want to achieve the long-term rates of return offered by the stock market, make a long-term commitment and avoid funds that try to time the market.

8) Is technical analysis used?
Studies indicate that most technical analysis provides an unreliable indicator of long-term future price action, with the exception of measures of relative strength. Avoid funds that rely heavily on technical analysis to the exclusion of an examination of fundamental factors concerning potential stock investments.

9) How is risk reduced?
Portfolio managers view risk very differently—for instance, some managers consciously try to assure diversification, while others consider overweighting or underweighting certain industries to be a risk-reduction method, avoiding the "riskier" areas. If you are going to invest in a fund, you need to be aware of how the manager views risk.

10) What would prompt a sale of an existing stock holding?
Very revealing of the portfolio manager's approach, and it should be consistent with his investment philosophy. The common thread among all portfolio managers who follow a consistent and well-thought-out investment approach is that stocks are sold whenever they no longer meet the manager's investment criteria, regardless of whether the stock is a winner or a loser for the manager.

growth at a discount."

Not all managers screen a large universe of stocks. For example, there is the "story" selection approach used by Peter Lynch, who made his investment fame managing Fidelity's Magellan Fund (Mr. Lynch was interviewed in the *AAII Journal* in September 1985). Mr. Lynch selected stocks based on well-grounded expectations concerning the firm's growth prospects, derived from the company's "story"—the story being what it is that the company is going to do, or what it is that is going to happen, to bring about the desired results.

All of these portfolio managers have produced good long-term performance records, but their portfolios look quite different.

Question No. 4: What "conditioning" or secondary characteristics do you look for?

A portfolio manager's initial criteria for selection will turn up a list of potential stocks, but there will be losers as well as winners. A good portfolio manager will have conditioning screens or other stock characteristics that attempt to weed out the kinds of losers that tend to turn up as a result of his initial criteria.

Good secondary screens are an indication that the portfolio manager is aware of the potential pitfalls of his approach, and, of course, it notifies you of those potential pitfalls, as well.

For the most part, these secondary screens are pretty standard, but they should be consistent with the initial selection criteria. For instance, Robert Hoffman, portfolio manager of the AARP Growth & Income Fund (interviewed in November 1994), invests in conservative dividend-yielding companies, and so he looks for companies with a healthy balance sheet and a commitment to paying the dividend.

Albert O. Nicholas, portfolio manager for the Nicholas Fund (interviewed in July 1984) uses primary screens that search for value—low price-earnings ratios, low price-to-book ratios, and high dividend yields. But the fund seeks mispriced stocks, not those that deserve low multiples, so he also looks for companies with a high return on equity and that are market leaders, with the best profit margins, product lines or service in their industry.

Question No. 5: How do you value a stock?

The answer to this should be consistent with the investment philosophy.

For example, O. Mason Hawkins, portfolio manager of Longleaf Partners Fund (formerly Southeastern Management Value Trust), described a value approach (in an interview in August 1993) in which he spends most of his energies on valuations, using three different valuation methods.

In the growth camp, however, Gary Pilgrim, portfolio manager of PBHG Growth, spends very little time on valuations:

"The market chronically undervalues companies that grow for an extended period of time. And if a company stops growing, it doesn't matter what the price-earnings ratio is—it's going to go down a lot. Not to be glib about it, but we don't find valuation tools to be very helpful in assessing the attractiveness of growth companies."

Question No. 6: What non-financial characteristics do you examine?

Many portfolio managers find it important to go beyond the statistics of the companies in which they are investing, to help understand the company and its operating environment.

For example, Gloria Santella, portfolio manager of the SteinRoe Capital Opportunities Fund, described her examination of corporate management in an interview in January 1996:

"I need to know what a company's strategy is, what its plans are, and then I look at their record. I assess the probability of whether they can achieve what they say they are going to do, and then we track them to see if they do it."

That approach is, in fact, what a prospective mutual fund investor needs to do with a fund manager.

Question No. 7: Do you time the market? By what percentage do you vary cash positions?

This is a red flag question, and a good illustration is provided by the Mathers Fund. In the interview in April 1988, portfolio manager Henry Van der Eb Jr. described himself as a value timer—if he can't find "value," he leaves the market. And the fund's performance figures for 1987 were impressive—it was up 26.2% at a time when the stock market was up only around 6%. That's because the fund had started exiting the market in March of 1987, and was 62% in cash by that October when the market crashed. By April of 1988, the fund was back in the market.

However, it is hard to get it right all the time, and while those two calls were on-the-mark, its subsequent calls have been off-the-mark. Since early 1995, the fund has been largely out of stocks, and the bull market stampede has left it in the dust; its three-year average annual return is 3.2% versus 31.0% for Vanguard's S&P 500 index fund.

John Markese, president of AAII, calls market timing the Broken Clock approach—it's always right twice a day. If you are investing in stock funds and want an equity rate of return, avoid funds that time the market.

Question No. 8: Are there any technical characteristics that you examine?

Most studies indicate that most technical approaches are not that successful, and few portfolio managers place very much emphasis on technical analysis. There is one type of technical analysis that has shown

promise, though, and that is relative strength, in which the price performance of a stock is measured relative to the price performance of an index, indicating whether the stock's price is trending up faster than other stocks.

An interesting use of this tool was indicated by James D. Oberweis, portfolio manager of the Oberweis Emerging Growth fund, a fund with a solid long-term track record, in an interview in June 1994:

"We use it not because we feel it's some kind of magical technical tool that tells us if the stock is a good investment, but rather as a check on reality. If a particular company looks very good to us but is underpeforming the market, I want to step back and say 'What am I missing?' There must be something wrong that other investors know about that I, for whatever reason, haven't been able to find or don't understand. If the relative strength isn't there, we may simply keep our eye on it rather than buy it."

Question No. 9: How do you reduce risk?

Portfolio managers view risk very differently. Some managers discuss conscious efforts to make sure they are diversified, so they are not overly concentrated within a particular industry, which can happen when using any screening process.

Conversely, other managers consider overweighting or underweighting certain industries to be a risk-reduction method—they stay out of the "riskier" areas.

Sector fund managers tend to discuss the various market segments within the industry, and which companies are riskier. They may try to limit their exposure to those areas.

Interestingly—and perhaps this is not too surprising—some portfolio managers consider their stock picks to be risk reduction.

You may disagree with whether these measures actually lower risk, but you do need to know about them if you are going to invest in the fund.

Question No. 10: What would prompt you to sell a stock?

This is a key question that reveals much more than you may think.

Every portfolio manager will have his own specific reasons for selling stocks. For instance, Lawrence Auriana, portfolio manager of the Kaufmann Fund, invests in small emerging growth companies, but he sells his holdings if they are taken over, when they have reached a stage where they need a different type of management. Albert Nicholas sells his "value" stocks when valuations get too high relative to the market, or relative to other potentially undervalued stocks.

However, there is a common thread among all of the reasons that tend to be given by portfolio managers who follow a consistent and well-thought-out investment approach, and that is that a stock will be sold whenever it no longer meets the manager's investment criteria.

It may no longer meet that criteria because it has done what the manager wanted—it's gone up in price—and he feels that it has gone up about as far as his approach is capable of judging it.

Or, the stock may no longer meet his criteria because somehow the company has fundamentally changed or the portfolio manager realizes he made a mistake and the stock never really met his criteria in the first place, or another stock better meets the manager's investment criteria.

But the stock is always judged on its own current investment merits relative to the manager's investment criteria; share price alone is almost never mentioned, and price drops are frequently viewed as buying opportunities, particularly if due to an overall market move.

The point is, in order to sell a stock, a consistent portfolio manager must have a pretty clear idea of why he bought the stock in the first place. So the answer to this question gets to the heart of a portfolio manager's investment approach, and the answer needs to be consistent with the manager's overall investment philosophy and selection criteria.

FINDING THE ANSWERS

If you can get the answers to most of these 10 questions, you will have a pretty good understanding of the investment approach that is being followed by a mutual fund portfolio manager.

Whether that approach is the best approach, of course, is another judgment you will have to make, but you can't make any judgment regarding this important issue if you have no idea what your mutual fund manager is doing.

Where can you get the answers to these questions?

Some funds do include at least some of this information in their marketing literature, in the fund's annual reports, and sometimes in the prospectus.

In addition, many funds send out newsletters to shareholders that provide more detailed information on their portfolio managers' approach. If you are not a shareholder but a prospective investor, ask the shareholder representative if any of this explanatory literature can be sent to you.

The Internet is another source. More and more mutual funds are setting up their own Web sites, and some of these include fund manager Q&As.

Lastly, there are magazines such as Forbes, Barron's, Fortune, and, of course, the *AAII Journal*, which do fund manager interviews.

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