

# COMBINING DIVERSIFICATION WITH A CONCENTRATED STOCK PICKING-APPROACH

## FUND FACTS

### MASTERS' SELECT EQUITY FUND—(MSEFX)

#### CATEGORY:

Growth

#### PERFORMANCE: (thru 3/31/00)

	Fund	Category
Compound Annual Return (%)		
1 Year	30.4	26.3
3 Years	26.8	22.5
5 Years	na	21.7

#### RISK: (relative to category)

Above Average

#### TOTAL ASSETS: (as of 4/30/00)

\$450 million

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*Can you have both a concentrated portfolio that is at the same time diversified?*

*It sounds like a contradiction, but that in fact is the underlying philosophy behind the Masters' Select Equity Fund. The fund divides its assets among a diversified group of "star" portfolio managers known for their stock-picking skills, who each run concentrated portfolios of their best stock ideas.*

*The fund is still young—it was launched in 1996 by Litman/Gregory Fund Advisors—and therefore a long-term performance record has not been established. The fund outperformed its peers in 1997, 1999 and for the past three-year period; and it outperformed the S&P 500 in 1999.*

*Currently the fund has \$450 million in total assets.*

*One of the founders of the fund, Ken Gregory, wrote a regular Mutual Funds column for the AAI Journal from 1989 to 1992. We decided to take a look at how he puts his advice into practice. Maria Crawford Scott discussed the management of the fund with him in early May.*

### **Why did you start the Masters' Select Equity Fund—what was the philosophy behind it?**

For years we have done a lot of due diligence and research on stock-pickers who are running mutual funds. In the process, we came to believe that a lot of stock-pickers don't view all of their stocks equally—they have a higher level of conviction with respect to some of the stocks that they own. We also noticed that, as mutual funds grew in terms of their asset base, they tended to expand the number of holdings they have out of necessity, so many of the stocks they were holding were not their top picks.

Back when we started thinking about putting this fund together there really weren't any concentrated funds. Now there are some, but not a lot. I believe the reason for that is that it's hard to run a lot of money in a concentrated strategy. Also, concentration tends to result in more volatility.

Our thinking was that it would be nice to get the benefits of concentration, but without the volatility that you risk by running a 10- or 15-stock portfolio. So we came up with this idea: What if we were able to pull together a number of excellent stock-pickers that we felt could run a high-conviction concentrated portfolio of up to 15 stocks, and put them together in a single fund so that we would have a lot of diversification?

We also had an objective of making this basically a core type of equity holding—something that would appeal to people who wanted a broadly diversified equity fund that gave them reason to be confident that it would do well over a complete market cycle.

### **What is the current structure of the fund?**

We have four managers who focus mostly on mid-sized and larger companies. Spiros Segalas, portfolio manager of Harbor Capital Appreciation Fund, is a pure large-cap growth manager. Shelby and Christopher Davis, managers of the New York Venture Fund, are often classified as value managers but we feel they are more growth-at-a-reasonable-price managers. Longleaf Partners Fund manager Mason Hawkins is a value investor. And William Miller, who manages the Legg Mason Value Fund, is an eclectic manager who owns a variety of different types of stocks, ranging from beaten-down value holdings to stocks that most people would consider growth. Each of these managers

has roughly 20% of fund assets.

We also have two managers with mandates to be small- to mid-cap investors, with a bias towards small. Those managers are Dick Weiss, portfolio manager of the Strong Common Fund, and Foster Friess, portfolio manager of the Brandywine Fund. Weiss is a growth-at-a-reasonable price manager, while Friess focuses on growth. Each of these managers has roughly 10% of fund assets.

Basically, we have a fund that fairly consistently has been 20% small cap, 45% to 55% large cap, and the remainder mid cap, and it has both value and growth stocks.

Also, all of our managers can put a small portion of their portfolios in non-U.S. companies, except Mason Hawkins can go up to 50%. So we have the potential to have some foreign exposure, and that's ranged from 4% to 17% over the life of the fund.

In terms of how the portfolio has been structured over time, it's truly a very diversified fund. Yet each manager is focusing on a concentrated portfolio of up to 15 of their best picks.

***How do you evaluate the managers when you are selecting one to manage part of the fund?***

Basically we start by looking at track records. We're fairly lenient there, looking for managers that are in the top third of their category and ahead of their benchmark over the long term. But we're not trying to look for top performers at that level. That's just a quick screen.

Then we do due diligence on the managers, which focuses on understanding their investment process. We have them fill out a very lengthy questionnaire, and then we go through it with them verbally. We're looking for an investment process that's well-defined. We think that one of the things that differentiates good stock-pickers from less effective stock-pickers is a discipline that cuts down on the decision errors.

Once we understand the process, we spend a lot of time focusing on the execution of it—talking stocks with them, having them go through different stocks that they own, so that we can see evidence that they're actually executing their process in a manner that is consistent with how they've described it. We also go through and meet with the analysts to assess the quality of the team and to look for consistency in their approach.

We also want to figure out who the key people are. We want managers who are highly focused, who don't have a lot of other distractions, who aren't doing a ton of marketing or have a lot of business management responsibilities, and who aren't running eight different types of portfolios. We think that focus is very important. We also look for managers who are obsessive about gaining an edge.

Finally, it's important that the stock-picker be a highly convicted stock-picker—they have to be able to convince

us that they're able to differentiate between their favorite holdings and other holdings.

***Do you find that a particular style is better for a certain part of the market? Do you favor, say, the growth style for the smaller-cap portion of it?***

We didn't really do it that way. If you look at the markets historically, it does seem to have been easier for smaller-cap growth managers to beat small-cap growth benchmarks than it has been for small-cap value managers to beat small-cap value benchmarks. But basically on the small-cap side we hired two managers that we had the most confidence in, in terms of our really being able to identify what their edge is, and feeling that they could execute a concentrated strategy. So, that is how we made our decision.

***In the Masters' Select Equity Fund, each manager is allowed to own up to 15 stocks. Have they varied that by much? Roughly how many stocks does each manager own, and are they allowed to hold cash?***

It varies by manager. Most of them have held between 10 and 15, with a couple of them consistently holding 13 to 15. One of them, Hawkins, has never owned 10—he's averaged between five to eight.

We've given the managers the ability to hold up to 20% cash, but we've also told them that because they only have to come up with a small number of names that they're truly excited about, our expectation is that they would be close to fully invested most of the time. We have had a couple of instances where managers have held anywhere from 8% to 15% cash over a short period of time, but on the longer-term basis their cash has ranged from 0% to 4%. A lot of times when they are holding more cash, it's transitional.

***How do you rebalance the fund? Do you allow one style to predominate if it is doing well?***

We have no intention of actively managing the style exposure or the amount of allocation that each manager gets. We think that we have great stock-pickers and a structure that will allow them to perform well, so we don't want to mess that up. We want to be about equally weighted between value and growth.

However, rebalancing is another question. There are a number of things that are our responsibility—picking the stocks is not, but rebalancing is. Basically, what we try to do is use cash flows into the fund to rebalance, so that if one manager is outperforming another, he's going to end up getting less of the new cash. As the fund has grown, that's gotten harder because our cash flows as a percentage of the overall fund's asset base aren't as big.

In addition, if the managers are holding a small amount of cash, sometimes we'll take that cash from one and give it to another to try and balance things out.

But also, we're not trying to be too exact here. We

will let our allocations drift. Up until this point in time, we haven't had an instance where we've gotten so uncomfortable with the amount of allocation drift that we've made a decision to actually take money from a manager that would require him to sell stocks. So, we think the combination of cash flows, the ability to allow for a few percentage points in drift and the ability to take cash, if they're holding cash, at any point in time—the combination of those things has been enough to keep us roughly in balance.

***How do you evaluate each manager's performance?***

Basically, we believe that because each of them is running a very concentrated portfolio, their performance is going to be more volatile than a more diversified portfolio. As a result, we have to be careful about evaluating performance over short periods of time. No matter how good a stock-picker is, sooner or later they're going to go through a period where they don't perform well. The question we have to ask at that point is: Is this just a rough period that they're going through or is there some reason to believe that something has changed and that our confidence in their ability to pick stocks successfully should decline? We evaluate performance over at least two-year periods of time, but not shorter, unless performance is truly horrible and we think they've made a number of mistakes that they shouldn't have made. But in general, we tend to be patient, and I think our confidence here is the result of a huge amount of upfront work that we do to get comfortable with them in the first place.

***What about their performance relative to their own mutual funds that they're managing?***

Basically, the way we are evaluating the success of this concept is in two parts. One, we want to see the managers in aggregate and individually beating their own benchmarks most of the time. We don't expect them to beat their benchmarks year in and year out, but we do expect it most of the time and over longer periods of time. Two, we want to see them outperforming their own funds. We want to see validation of our concept—that there really is some value added from concentrated investing.

Through April of this year, and since the inception of the fund, Masters' Select Equity was up 98.8%, while the weighted average of our managers' own funds was 73.3%. If you look at it individually, there's only one manager that hasn't outperformed his own fund and he is almost in a dead heat with it.

***How does the industry diversification of the Masters' Select Equity Fund compare to the overall market? For instance, what's the commitment to technology?***

Our technology exposure has grown over time and

we're a little bit less than a market weight now—we're about 29% in technology.

I watch the industry diversification, and it has consistently been quite well diversified. But I don't know specifically how it compares to the S&P 500. What I do know is that we have been much smaller-cap oriented than the broader market indexes, and that has tended to hurt us except in the last half year or so.

***What about the expense ratio?***

We're fighting hard to get it down. Last year we came in at 1.26%, which isn't too bad. It's not like buying a fund of funds, where you've got an underlying full-fund expense and another level of expenses on top of that. As our asset base grows, it's going to go down a little bit more—I think we can probably get it down to 1.20%, which is competitive.

***What about portfolio turnover? We only have figures from 1997 and 1998, but it's over 100%. Would that be typical?***

It's still kind of early to tell and it's hard to analyze for a couple of reasons. In general, the turnover for most, but not all, will tend to be a little bit higher than for their own funds. But also we've been very active in encouraging the managers to take into account tax swap opportunities—I would guess that anywhere from 10% to 25% of our turnover is driven by attempts to mitigate the tax impact.

***How frequently have you changed portfolio managers?***

For the most part the fund is pretty much unchanged from the way we launched it in terms of structurally how we wanted it to look. We replaced one manager after a little over a year, and that was the result of recognizing that he really wasn't comfortable running a concentrated portfolio. We also recently added Bill Miller to replace Robert Sanborn, who had been manager of the Oakmark Fund but had left the fund.

***Has the current market, which has favored growth and particularly large-cap growth, made it difficult to maintain your commitment to a balance between growth and value?***

We've totally removed that from consideration. Basically we made a commitment publicly and to ourselves that we're not going to style manage this—we've made it clear that what people are getting are fixed allocations and our judgment only comes into play from the standpoint of how to rebalance.

And our conviction toward that balanced approach, along with our conviction toward skilled stock-pickers selecting their highest-confidence stocks remains. We think this combination can deliver a truly diversified portfolio that can deliver market-beating returns over the long term. ♦