

## Point and Figure Special Report: Ouch! What To Do After a Bad Quarter

“Well come on and let me know  
Should I stay or should I go?”

The Clash

After every crummy quarter, a client who is employing a money manager has a decision to make. (Actually, this decision comes up every quarter, but for some reason clients never worry about a good quarter.) The market is a difficult place in the best of quarters—there’s always volatility and uncertainty. In this environment, with the normal market volatility coupled with underperformance, the hardest task for the investor is to have faith in the investment process and the manager they have selected and the patience to see it through. Indeed, it seems to be *the* distinguishing characteristic of a successful investor versus an unsuccessful one.

First, let’s address patience. Cambridge Associates, a money management consulting firm, did a study of the top-performing managers for the decade of the 1990s. In 2000, they could look back and see which managers had returns in the top quartile for the entire decade. Presumably, these top quartile managers are precisely the ones that clients would like to identify and hire. Cambridge found that 98% of those top managers had periods of underperformance extending three years or more. 98% is not a misprint! Even more striking, 68% of the top managers ended up in the bottom *quartile* for some three-year period and a full 40% of them visited the bottom *decile* during that ten years. Clearly, there are good and bad periods for every strategy. Harold and I have seen this repeatedly in our twenty years in the business. How many clients had the patience to sit through the three years of underperformance without wavering? Industry statistics are pretty clear on this point—very few. That’s why investor returns lag so badly behind the actual manager returns. Clients have a tendency to buy into top-performing managers and then pull out when they get nervous during the first drawdown. Unfortunately, only the clients who stay the course are rewarded with the full measure of performance.

Next, let’s address volatility. Here is what Peter Bernstein had to say about it in a recent question and answer session at a CFA Institute Conference\*:

In many instances, volatility will be a friend rather than an enemy. Indeed, I think the fascination with volatility leads to bad decision making. Success in equity investing must depend on an appetite for volatility. The smooth stuff is not where you make money. You're not going to get rich on Treasury bills. The ability to take risk and to go somewhere and have success depends on a set of human relationships just as much as it does on the mathematics of it.

Peter Bernstein is a wise man. He is 87 years old and one of the leading experts on the subject of risk. He started on Wall Street in 1951 and turned to consulting after managing money for more than twenty years. Although not an academic, he is the author of many books, including *Against the Gods: The Remarkable Story of Risk*.

Bernstein's comment is pithy, but it contains several important points. First, volatility is your friend, not your enemy. There is no excess return in Treasury bills and CDs like there is in stocks. In fact, high-performing strategies with a certain amount of volatility can be tremendous wealth builders. You just need to stick through the drawdowns, or better yet, add new funds during the dips. It's true that this is easier said than done, but if you can discipline yourself to add when things look bleak, returns can be terrific, as the following table shows. Obviously, the reason such high returns are available is because so few investors are willing to take the actions that will generate them.

The example below is generated from the hypothetical and real-time returns produced by our Systematic Relative Strength Aggressive strategy. Each time the portfolio declined 10% from its previous high point, Steady Eddie added another 10% of the current portfolio value to the account. Sometimes that was the end of the decline, but other times Eddie might be early and the account would continue dropping after he added his contribution. No matter. Eddie had conviction in the strategy. Flighty Frank, on the other hand, would get very nervous and stressed each time the portfolio dropped 10%. He would gnash his teeth, chew his nails, and generally white-knuckle it through every decline. As the account went to a new equity high, Frank would begin to feel better about things. Frank added an identical amount of money, but Frank would only add money each time a new equity high was exceeded by 10%, because things were obviously going so well. Steady Eddie was willing to invest when the outcome was uncertain, but Flighty Frank would only invest when he felt the coast was clear. The table makes clear which is the superior strategy. Eddie ends up with almost 10 percent

more money, and makes an extra \$339,274 on his total contribution of \$2,224,151, for an additional return on invested capital (ROIC) of 9.6%.

	Invest When Uncertain	Invest When Certain
Starting Value	\$100,000	\$100,000
Contributions	\$2,224,151	\$2,224,151
Ending Value	\$3,873,346	\$3,534,072
Difference in ROIC	+9.60%	

Second, Bernstein points out that the ability to take risk and succeed depends on a set of human relationships. In the context of Dorsey, Wright Money Management, those human relationships would consist of your financial advisor and us. We are both charged with making sure that you understand our investment process and that the strategy is appropriate for your long-term goals. At the time you went with Dorsey, Wright as a manager, you, too, felt this was a good fit. Our strategy hasn't changed; most likely, your long-term goals haven't changed either. If nothing has changed, the right course of action is to hang in there. In most cases, the only thing that has changed is the introduction of concern or doubt from a poor quarter—concerns that will generally be erased when the account goes to a new equity high in the future. (This happened twice in 2005 in our Systematic RS Aggressive accounts. After each drawdown, the accounts shortly went to a new equity high and ended up having a tremendous year.) The human part we can help with. We can, in forums like this, exhort our clients to stay the course. Your financial advisor may have given you the same advice to stick with it and reminded you that investing is a long-term endeavor. But we are also available for conference calls for clients and advisors who find themselves wavering in the face of circumstances that are less than ideal.

Client defections during drawdowns are an issue that has bedeviled the investment industry for decades. In a perfect world, no money manager would ever have to write a client note about it, but the fact is that every strategy—and we think we have one of the best—underperforms from time to time. Client turnover is never pleasant for managers, but if long-term performance is excellent, there are always new clients willing to step up when times are good. No, the real cost of bailing out during the tough times is unfortunately borne by the clients, in the form of severely diminished long-term returns. (Studies by research and consulting firms like Dalbar and CDA Weisenberger make this painfully clear. Please contact us if you want more details.) We don't want that to be the legacy of our clients. The whole

point of using a money manager in the first place is to augment your assets. We want every client to have a positive outcome and we'll do whatever we can to help our clients achieve it.

\*CFA Institute, Conference Proceedings Quarterly, September 2006