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Analyzing the sell side of the equation

Investors, both private and institutional, spend time and money pursuing the best investment products. Buying is only 50 percent of the equation, and mistakes are frequently made on the selling side.

PERSONAL FINANCE

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We have seen investor-written investment policies that are far too strict. If there's a short period of underperformance, that strictness leads to firing the managers involved and/or selling the product. This can hurt total portfolio performance.

Conversely, other investors seldom change managers and allow a poor manager to be a continued drag on total portfolio performance.

We believe investors and their advisers who are too trigger-happy fail to understand why a product has underperformed. It's not unusual for excellent products to underperform their benchmarks for three years or more.

Take Dodge & Cox Stock Fund – nearly everyone's large-cap value darling. Dodge & Cox has outpaced its peers handsomely – top 2 percent for two years and five years, and top 3 percent in the last 10 years.

However, 1998 was a different story with today's same management team and approach. The fund was below median against its peers for five consecutive quarters. Most investers begged for alternatives but failed to understand that Dodge & Cox's deep-value team historically added value with smaller, large-cap stocks.

The late 1990s were about speculation, earnings momentum and mega-cap stocks. Even Warren Buffett was criticized as having "lost it". Markets rotated, and Dodge & Cox (and Buffett) shined again.

Another recent example is Harbor Capital Appreciation. The fund did very well in the '90s as Sig Segalas, a pure growth manager, focused on earnings momentum, as he has since 1984. The period of 2000-02 was disappointing as earnings fell back and investors focused on hindsight were ready to go elsewhere. In 2003, growth had a big rebound. Consequently, selling the fund in 2002 would have been a mistake.

We have written many times that crunching numbers (past performance) should be only a small part of the decision to buy or sell a fund. However, a statistic that we do focus on is relative performance during rolling three-year periods.

Dodge & Cox has outperformed its peers in nine of 10 such periods while Harbor Capital outperformed in eight of 10 rolling three-year periods ended June 30. Nearly every manager will have a difficult period; batting. 700 or more is impressive.

In the last 18 months, growth at a reasonable price (GARP) managers have underperformed due to high-quality stocks significantly lagging low-quality stocks. In other words, cyclical companies that swing with the economy have outpaced steady growers such as consumer stocks and health care.

Investors are becoming impatient with the GARP approach, but we're confident their day is coming. The key is, and always has been, to understand why performance occurred – good or bad. This will go a long way in determining the sell side of the equation and capturing the returns that many investors fail to realize.

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