

A Famous *FALL* From Grace¹

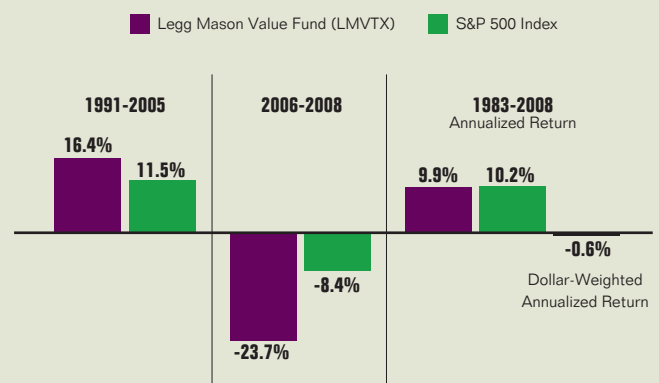
Although the phrase *A Famous Fall from Grace* has applied to many over the years, here we refer to **Bill Miller**, the world famous portfolio manager of the **Legg Mason Value Trust**. For decades prior to 2008, Mr. Miller was a leading investment manager. He showed an extraordinary ability to generate excess return in the Legg Mason Value fund (LMVTX). He did this by betting on stocks that beat the broad market (e.g., S&P 500 Index). The fund outperformed the broad market every year from 1991 to 2005 – a feat no other fund manager has been able to match. Over that 15-year period, LMVTX earned 16.4% per year while the S&P 500 returned 11.5% (see Figure 1). Mr. Miller’s fund earned an excess return over the broad market of 4.9%. However, his betting ability changed the last three years, and the fund has underperformed. For example, in 2008 his stock picks included AIG, Inc., Bear Sterns, and Freddie Mac. His method of buying cheap stocks, which he employed successfully for years, ceased to work in this extraordinary period. His fall from grace was swift. While the S&P 500 fell an average of 8.4% per year from 2006-2008, LMVTX lost an average of 23.7%, effectively wiping out the fund’s history of market-beating returns. In fact, LMVTX has now underperformed the S&P 500 going back to 1983 (the fund’s first full year in existence). Even more telling is the fact that most investors piled into the fund only after word had spread about its stellar performance (prior to 2006) and experienced a much lower return than the average return going back to 1983. **Incredibly, the dollar-weighted average annual return, which adjusts the return to show what the average investor actually experienced, is -0.6% per year. This means that the average investor in the fund actually lost money going back to the inception of the fund in 1983.** In contrast, the S&P 500 earned 10.2% per year during the same period of time. How could this be? Given that the fund reached its peak in assets under management in 2004 (one of the last years it managed to beat the market), most investors never experienced the market-beating returns that inspired investors to buy the fund in the first place. Still, they got all the recent underperformance due to Miller’s miserable stock picking from 2006-2008.

Passive versus Active Investing

Bill Miller is an example of an active investment manager. The active manager attempts to beat the market by picking superior stocks and also rotating from one investment to another. Passive management, which RCG employs, is a very different approach. Passive investors buy all stocks or a large sampling of available securities to replicate an index such as the S&P 500.

Active managers frequently claim that a big advantage they have over index funds is their ability to forecast market events and then time the market’s decline or recovery. They purport to have the ability to avoid the worst stocks. They argue that “boring” index strategies do not have the flexibility to time the market, inevitably giving active managers an advantage during the worst of markets. If that was true, the financial crisis of 2008 should have been the perfect time for active managers to demonstrate their skills. Clearly, this was not the case with Bill Miller’s fund. In fact, Figure 2 shows that in 2008, **the average U.S. equity mutual fund failed to beat its passive benchmark in eight out of nine categories.** The story is the same for international and emerging markets equity funds as well

FIGURE 1: PERFORMANCE OF THE LEGG MASON VALUE FUND (ANNUALIZED RETURNS)



Source: Morningstar EnCorr and Savant Analysis

Figure 2: ACTIVE FUNDS VS. PASSIVE BENCHMARKS: THE TYPICAL ACTIVE MANAGER FAILED IN 2008

U.S. EQUITY FUNDS

	Lipper Average Fund Return			Index Return			Difference*		
	VALUE	BLEND	GROWTH	VALUE	BLEND	GROWTH	VALUE	BLEND	GROWTH
Large	-37.40	-37.20	-40.70	-39.22 S&P 500/ Citi Value	-37.00 S&P 500	-34.92 S&P 500/ Citi Growth	1.82	-0.20	-5.76
Mid	-38.30	-38.50	-44.50	-34.87 S&P 400/ Citi Value	-36.23 S&P 400	-37.61 S&P 400/ Citi Growth	-3.43	-2.27	-6.89
Small	-33.50	-36.20	-42.10	-29.51 S&P 600/ Citi Value	-31.08 S&P 600	-32.94 S&P 600/ Citi Growth	-3.99	-5.12	-9.16

Source: Lipper Average published in *The Wall Street Journal*, January 6, 2009 & Morningstar EnCorr

*Negative number indicates active managers underperformed indexes.

¹ Main article used with permission of Savant Capital Management, a fellow ZAG firm.

as taxable bonds (Figure 3). Considering that the Lipper averages for each category also include many passive index funds that closely track their benchmarks, the performance of active managers has been dismal. **Active managers failed when they were supposed to shine.**

A recent article in the Wall Street Journal² concluded that indexing wins the race between active versus passive investing. Scott Burns, an analyst at Morningstar, went on to explain that:

As well as the lower returns, investors in actively run funds are more likely to chase performance and less likely to be focused on asset allocation. As such, they are quicker to dispose of their holdings. Index-fund investors, meanwhile, more often use those funds as part of an asset-allocation strategy that see them through tough times in the markets, Mr. Burns said. The style, he added, “gains more converts” after each market downturn. Actively managed stock funds saw net outflows of \$221.8 billion in 2008, while index funds saw net inflows of \$17.6 billion, according to data from fund-tracker Lipper Inc.

Figure 3: ACTIVE FUNDS VS. PASSIVE BENCHMARKS

INTERNATIONAL EQUITY AND BOND FUNDS

	Lipper Avg Fund Returns	Index Returns	Difference
Europe	-47.00	-46.08 (MSCI Europe)	-0.92
Pacific	-45.90	-36.17 (MSCI Pacific)	-9.73
Emerging	-55.50	-53.74 (S&P IFCI Composite)	-1.76
Bond Funds			
Avg. Taxable Bond Fund	-7.70	5.24 (Barclays Capital Aggregate Bond)	-12.94

Source: Lipper Average published in The Wall Street Journal, January 6, 2009 & Morningstar EnCorr

Major Cost Difference

Active managers demand to be paid handsomely for their potential ability to add excess return. Investors in Bill Miller’s LMVTX pay 1.68% per year to own the fund. Many active funds charge even more. Passive investing is far less costly than active investing. Passive investing avoids the big expenses related to employing portfolio managers or research analysts. For example, the Vanguard 500 Index Fund charges investors just 0.15%. RCG clients pay even less, only 0.07%, because our scale allows us access to an even less expensive share class.

Mark Kritzman, president and chief executive of Windham Capital Management of Boston, published a study that was recently cited in The New York Times³. The purpose of the study was to:

Accurately measure the long-term impact of all the expenses involved in investing in a mutual fund or hedge fund. Those include transaction costs, taxes and management and performance fees. Mr. Kritzman calculates that just to break even with the index fund, net of all expenses, the actively managed fund would have to outperform it by an average of 4.3 percentage points a year on a pre-expense basis. For the hedge fund, that margin would have to be 10 points a year.

Value Proposition

You may be wondering why investors would pay hefty expenses for a fund with performance that does not add excess return. Wouldn’t it be better to buy a less expensive fund with superior performance? For example, investors who purchased the Vanguard S&P 500 fund in 1983 could have earned slightly more return with a lot less volatility and tax. Volatility matters. Lower volatility helps us sleep at night.

Bottom Line

A major point, not to be overlooked, is that Mr. Miller took over twenty-six years to prove that passive/index investing is superior. Investors are wise to avoid high costs of active funds that promise the moon. Index and passive funds offer a better opportunity in all markets – good and bad. The key is patience, discipline and holding true to the buy-and-hold philosophy.



resource consulting group

Resource Consulting Group, Inc.

The Systematic Financial Solution™
301 East Pine Street, Suite 300
PO Box 4930
Orlando, Florida 32802-4930

Telephone: (407) 422-0252 or (800) 448-0252

Fax: (407) 649-8795

E-mail: info@ResourceConsulting.com

² Active vs. Passive: Indexing Wins '08 by Sam Mamudi published in The Wall Street Journal, March 5, 2009.
³ The Index Funds Win Again by Mark Hulbert published in The New York Times, February 22, 2009.