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Since Inception and Perception

"The highest returns going forward are when you have the lowest returns looking backwards." – Seth Klarman

When evaluating a money manager's performance, investors often cast their eyes across the time horizons to the longest term number – since inception. A positive relative return can be such a great comfort; a validation of the investor's original selection and a reflection on the quality of the manager.

On the other hand, a negative number, whether in relative or absolute terms, might suggest the opposite: that the original selection process was flawed or that the manager lacks quality or skill.

Or does it? Let's consider an example:

Relative Returns Against Respective Benchmark (Compounded, Gross of Fees)

	First Year (%)	Third Year (%)	Fifth Year (%)	Seventh Year (%)	Since Inception (%)
Fund A	5.32	1.94	2.85	1.50	1.70
Fund B	-8.32	-1.22	0.52	0.25	0.34

Fund A started off strongly, outperforming its benchmark by 5.32% in the first 12 months following its inception date. It continued to deliver solid compound returns and demonstrated solid alpha; while providing an acceptable return to investors, with less volatility than the benchmark. An investor would likely feel reasonably comfortable with their choice of investment manager and may be hopeful that another great relative return year will come along, further strengthening the since inception performance. The investor would be reaffirmed in their belief that the manager has a good reputation for consistently delivering good quality, risk-adjusted returns and would appreciate having a solid, dependable manager in their roster.

Fund B's manager, on the other hand, underperformed the benchmark in the early days. The manager's relative performance was underwater over the first few years, and started to deliver value-added returns in year five. While the manager performed with less volatility, it still only delivers index-like returns over the long term. The investor may be getting restless with the manager and may start to ask for explanations regarding the portfolio's stock positions and sector exposure.

Perhaps what some would find surprising is that, in this example, both of the funds were overseen by the same manager. However, there is one important difference: timing of the original investment. The inception dates of these funds were only five months apart.

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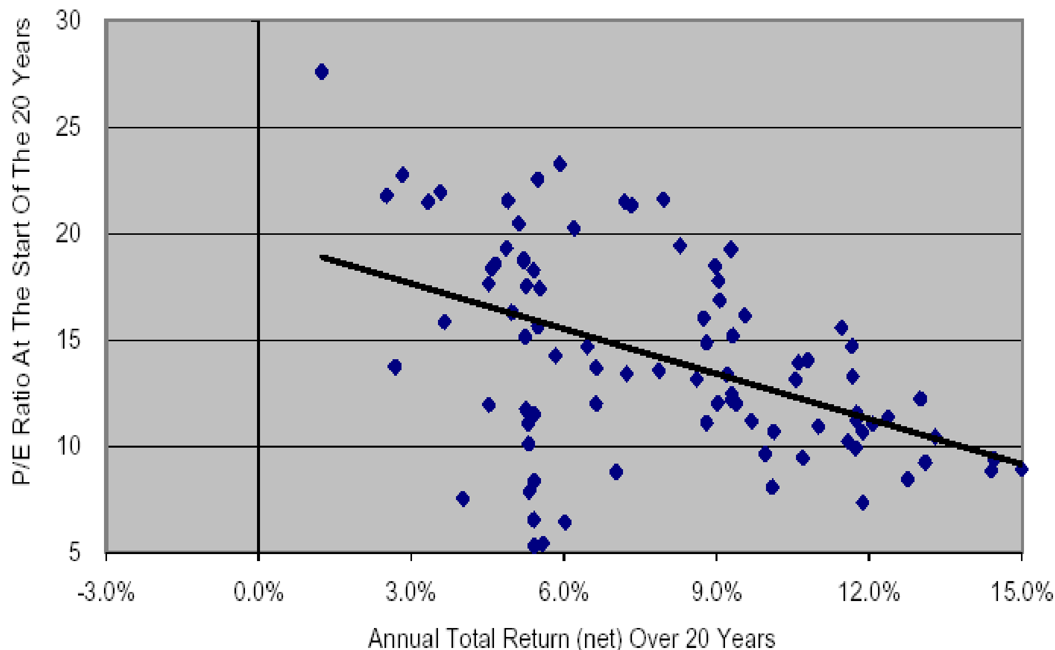
The inception date of Fund A was five months earlier. At that time, the manager was underperforming the benchmark on a four-year basis. The investor understood that hiring a manager when its style was out of favour might actually result in solid longer returns for their fund.

Fund B's inception date was following a period of strong outperformance. The investor might have unwittingly selected a manager when its style is at a peak level; if that's true, the manager's returns may float downwards until its investment style returns to favour and its quality reasserts itself.

Value investors believe that the price you pay when entering a security (or market) has an impact on the associated long-term returns for that investment. Measuring returns from the stock market peak of 1965 to the tech bubble peak of 2000 reinforces this point: compounded returns for that period were just 6.7%. Paying too high a price in the mid '60s just couldn't be recovered in spite of a decade of strong double-digit returns in the '90s.

The following chart, which captures 107 years of stock market returns, reinforces the negative correlation between valuations and returns. The data shows that investments made at attractive valuations were far more successful than those investors that were less disciplined about the price at their entry point. This concept resonates with us since we look for high-quality companies that are temporarily undervalued. We focus on the long-term potential of the investment, rather than the short-term noise that can impact valuations.



Source: Crestmont Research (www.crestmontresearch.com)

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Although the above chart focuses on the stock market overall, it wouldn't be surprising to us if a similar pattern emerged when looking at manager returns. Too often, managers experience a huge influx of search activity following a good run of performance; led by investors that are chasing impressive short-term returns. Not surprisingly, they may be setting themselves up for some challenges in the future.

Conversely, quality managers are often avoided following a period when their style may have been out of favour and performance correspondingly has been weak. However, if the manager has been steadfast in their approach and remained disciplined through that challenging period, it may be a good time to invest with them. This contrarian approach requires investors to ignore shorter-term results and instead recognize the investment opportunity. Sadly, not enough investors are willing to step away from the crowd to take advantage of the value a quality manager represents during those periods.

Some might interpret the foregoing as an argument in favour of market timing. Far from it. Instead, we intend for it to serve as a reminder to investors to be mindful of where a manager and their style is in the cycle.

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