2011: A Difficult Year for Active Investors

Summary

- Actively managed mutual funds greatly underperformed their respective benchmarks in 2011.
  - This was primarily due to extreme market conditions triggered by the European debt crisis.
  - Investment managers were not rewarded for good fundamental decision making as fear dominated trading activity in the global markets.
- Active manager underperformance / outperformance trends tend to be cyclical, but over time, good active managers add value.
- We expect actively managed funds to outperform once market volatility subsides and fundamental factors reemerge as a key consideration for investors.

The Year in Review for Active Management

Active fund managers work diligently to select specific stocks and bonds within a defined discipline with a goal of outperforming "the market," which is generally defined by an index such as the S&P 500. In 2011, three of four mutual funds failed to beat their benchmark index, and in many cases, failed miserably. According to a recent Bloomberg article[1], 2011 was the worst year for actively managed funds since 1997. Mutual fund managers weren't the only investors who struggled this year. According to a recent Barron's article[2], hedge funds trailed the S&P 500 by an average of 4% on a year-to-date basis through November.

To illustrate, we have prepared a comparative study of eleven common investment categories (below). As you can see, only 28% (item a) of the funds in our study successfully beat their benchmark for the year. Certain categories were hit particularly hard. Most notably, large cap growth funds (item b) trailed the Russell 1000 Growth Index by an average of 5.1% for the year and only 9.3% outperformed the large cap benchmark. Intermediate bond funds (item c) also had a very difficult year as bond funds trailed the Barclays Aggregate Bond Index by an average of 2% and only 8.9% outperformed the benchmark.

Managers in only two of the eleven listed categories achieved results that on average were better than their benchmarks; small cap blend (item d) and small cap value (item e).

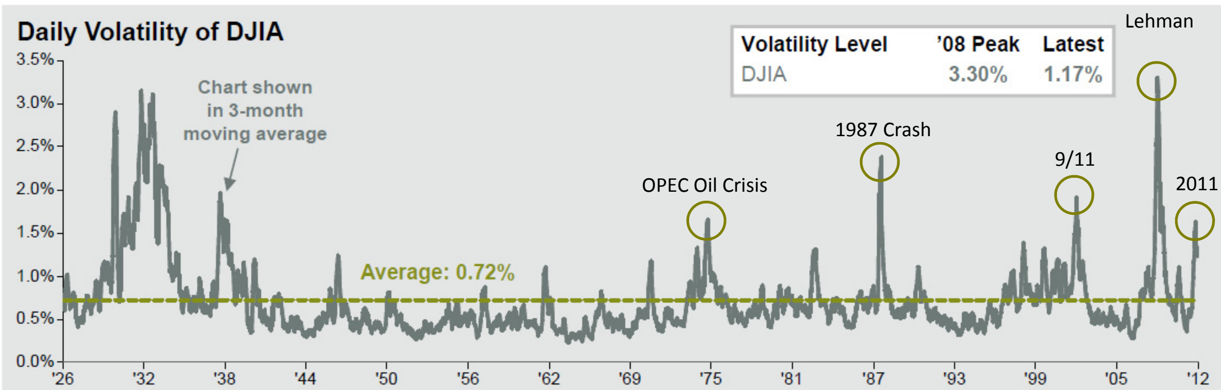
2011 Average Mutual Fund Performance vs. Benchmark

Category	Category Avg Return	Benchmark	Benchmark Return	Return Difference	% Beating Benchmark	
Large Blend	-1.33%	Russell 1000	1.50%	-2.83%	25.4%	
Large Growth	-2.47%	Russell 1000 Growth	2.64%	-5.11%	9.3%	(b)
Large Value	-0.77%	Russell 1000 Value	0.39%	-1.16%	37.7%	
Mid Blend	-3.81%	Russell Mid Cap	-1.55%	-2.26%	25.9%	
Mid Growth	-3.97%	Russell Mid Cap Growth	-1.65%	-2.32%	32.6%	
Mid Value	-3.96%	Russell Mid Cap Value	-1.38%	-2.58%	30.0%	
Small Blend	-4.06%	Russell 2000	-4.18%	0.12%	57.7%	(d)
Small Growth	-3.55%	Russell 2000 Growth	-2.91%	-0.64%	46.0%	
Small Value	-4.45%	Russell 2000 Value	-5.50%	1.05%	63.1%	(e)
International	-13.95%	MSCI EAFE	-12.14%	-1.81%	26.0%	
Intermediate Bond	5.86%	Barclays Aggregate Bond	7.84%	-1.98%	8.9%	(c)
				Total for all Categories	28.1%	(a)

Source: Morningstar, Russell, Barclays Capital, MSCI. This table is not recommending any security.

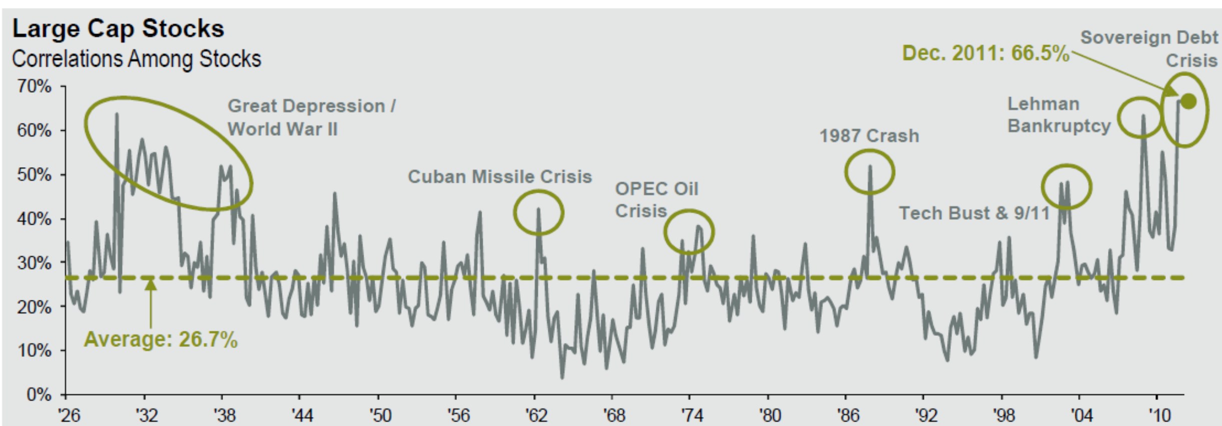
A Treacherous Environment for Equity Investors

The most damaging factors affecting actively managed mutual fund performance this year were the extreme market conditions that were triggered by the cantankerous debt ceiling debate and the eruption of the European debt crisis during the summer. Volatility spiked to levels seen only during market panics (as indicated in the chart below). At the worst of the panic, the Dow Jones Industrial Average had 400+ point swings for four consecutive days, a streak that is unprecedented. For the month of August, the S&P 500's average daily change was 2.2% which is the highest level since 1934, according to Bloomberg[1].



Source: Dow Jones, J.P. Morgan Asset Management[3]. Data are represented as three-month moving averages of the daily absolute percentage change in the Dow Jones Industrial Average. Data as of 12/31/11. This chart is not recommending any security.

In addition to volatility, correlations among stocks, which is a measure of the degree to which stocks move together, reached an all-time high this year (below). For months, stocks moved in lockstep, up and down, in reaction to the constant news flow out of Europe.



Source: Empirical Research Partners LLC, Standard & Poor's, J.P. Morgan Asset Management[3]. Capitalization weighted correlation of top 750 stocks by market capitalization, daily returns, 1926 – Dec. 23, 2011. This chart is not recommending any security.

The difficult combination of very high volatility and historically high correlations left fund managers severely handicapped. The traditional fundamental factors an investor would ordinarily consider, such as the quality of a company's balance sheet or the growth of its earnings had no bearing on the day-to-day movement of its stock price. Instead, fundamental analysis proved useless; as stocks moved wildly and collectively, based on macroeconomic and political concerns, even when these concerns had no tangible effect, directly or indirectly, on a stock's intrinsic value.

Further, it has been the trend over the last decade for domestic equity managers to include an increasing number of international investments in their portfolios as a way to express a more global view of expected economic growth. Foreign stocks, as measured by the MSCI EAFE, underperformed the S&P 500 by more than 14% in 2011, resulting in additional underperformance by "domestic" mutual funds. The consensus outlook for growth in early 2011 also negatively affected many managers who positioned their portfolios in stocks expected to benefit from continued global growth. The stock prices of these cyclically sensitive companies were among the worst performers during the summer downturn.

A Flight to Safety Batters Bond Funds

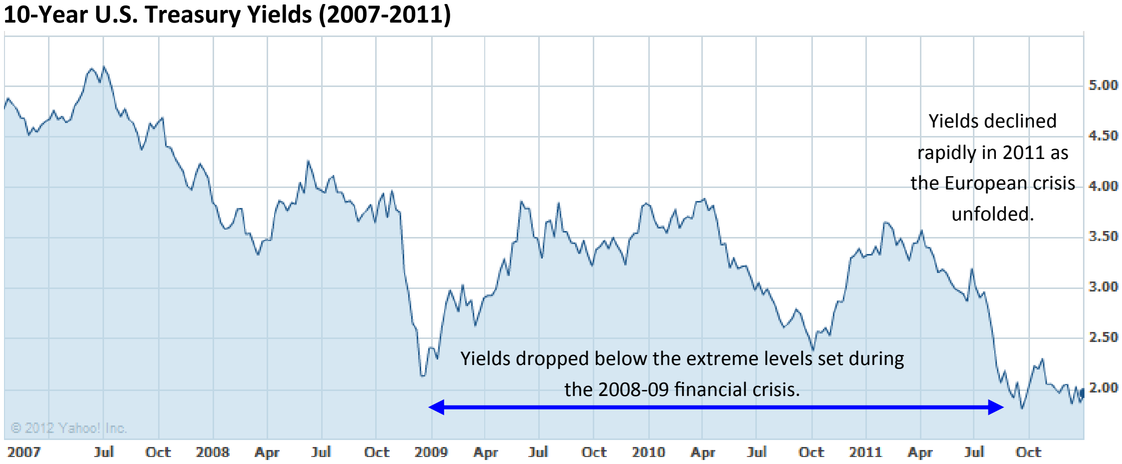
It wasn't just equity fund managers that found their portfolios in the wrong position when the summer panic hit. Earlier in the year, most bond fund managers positioned their portfolios away from low yielding U.S. Treasury bonds. At 3.3%, yields for 10-year Treasuries were near historic lows (below) and many believed that the 30-year trend of declining yields would soon end, which would cause the value of Treasury bonds to decline. With this expectation, most bond managers reduced their Treasury bond positions and increased positions in corporate and international bonds which offered better yield opportunities.

10-Year U.S. Treasury Yields (1962-2011)

Source: Yahoo! Finance. This chart is not recommending any security.

When the panic hit the bond market during the summer, and despite the downgrade by Standard & Poor's, investors rushed into the safety of U.S. Treasuries, pushing yields below the historic lows set during the 2008-09 financial crisis (below), which caused prices for Treasury bonds to spike higher. At the same time, investors dumped most other types of bonds, most notably high-yield corporate and foreign government bonds, causing their prices to drop.

10-Year U.S. Treasury Yields (2007-2011)



Source: Yahoo! Finance. This chart is not recommending any security.

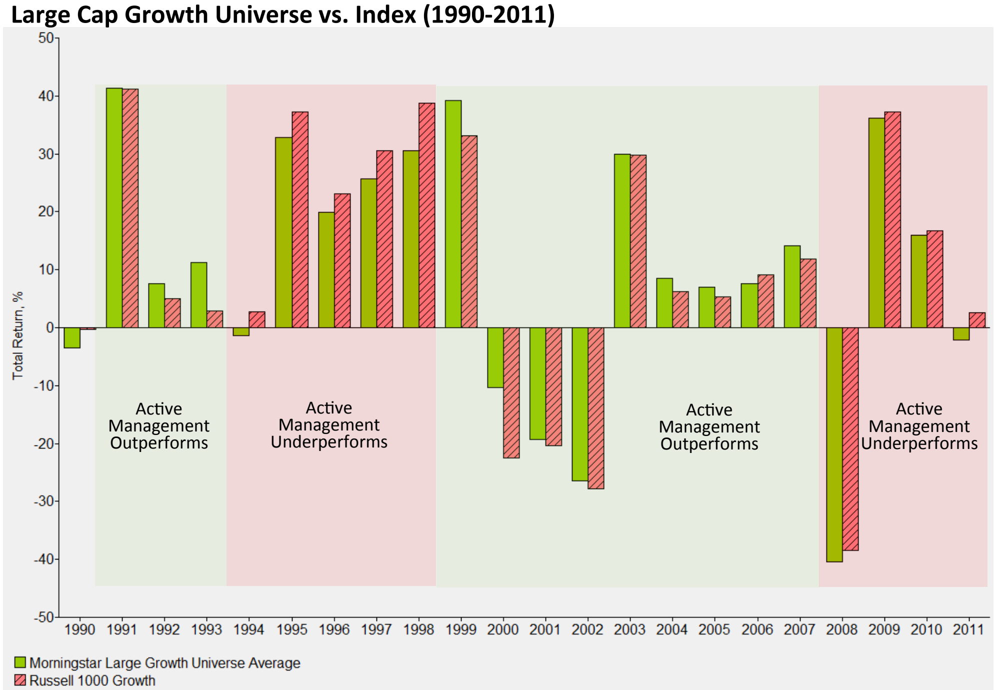
For most bond experts, the decision to avoid U.S. Treasuries at the beginning of 2011 was supported by the view that their extraordinarily low yields would move higher, which seemed likely given the strong evidence of overall economic improvement. Instead, yields moved sharply lower resulting in a 17% return for 10-year Treasuries, according to J.P. Morgan[3]. The absence of U.S. Treasuries in most actively managed bond portfolios caused them to significantly under-perform the Barclays Aggregate Bond Index, which has more than a third of its holdings in U.S. Treasury bonds.

A Perspective on Active vs. Passive Fund Management

Many in the investment community have argued that investors are best served by simply investing in passively managed index funds, which are designed to mimic the performance of an index, like the S&P 500. The difficult year active managers experienced in 2011 adds new evidence to support their view. But there are many examples of active investment managers who have achieved market beating track records over long periods of time, such as Warren Buffet, Bill Miller, Peter Lynch, and Bill Gross, to name a few.

While it is fair to claim that, at times, active managers have a difficult time beating the market, there are many times when the opposite is true. The chart below illustrates the average performance of large cap growth funds versus the Russell 1000 Growth Index for the past two decades. As you can see, active manager outperformance and underperformance tends to by cyclical, where active managers will outperform for a period of time, and then underperform for a period of time. We are currently in a cycle where active managers have underperformed.

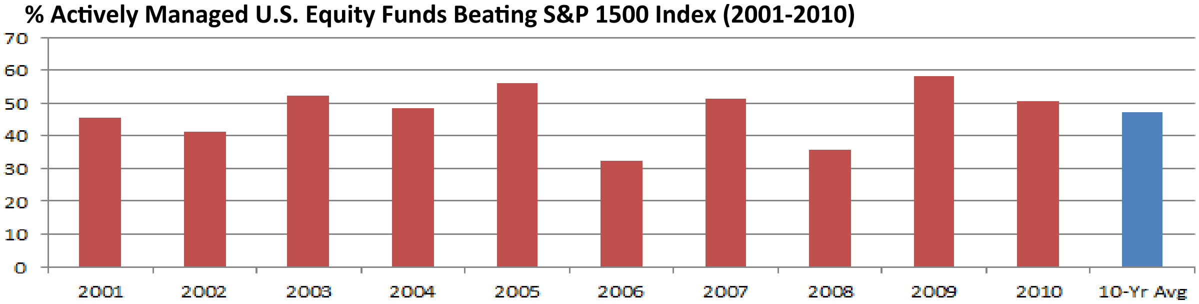
Large Cap Growth Universe vs. Index (1990-2011)



Source: MPI Stylus, Morningstar, Russell. This chart is not recommending any security.

However, over longer periods, the differences tend to even out. The group of large cap growth funds shown above has returned an average of 2.55% per year for the last 10 years, which is nearly identical to the 2.60% returned by the Russell 1000 Growth Index. The chart below represents a broader view of active manager performance. This study, based on data provided by Standard & Poor's[4,5], shows that for the decade ending in 2010, 47% of all actively managed U.S. Equity funds have outperformed the broad U.S. Equity Index, the S&P 1500. This suggests that there is little difference between the average performance of actively managed funds and passively managed index funds.

% Actively Managed U.S. Equity Funds Beating S&P 1500 Index (2001-2010)



Source: Standard & Poors[4,5]. This chart is not recommending any security.

A Case for Staying the Course

After such a dreadful year for active investment managers, it is tempting to ponder why an individual investor would choose actively managed mutual funds when passively managed index funds are so reliable. Put simply, the reliability of index funds is that they will always underperform their respective indexes. By definition, index funds will underperform their benchmark index by the amount of their expenses 100% of the time.

Active management provides long-term investors the opportunity to do better. Great investment funds will underperform from time to time, but given enough time, they often will provide better than market returns.

However, it is important to differentiate between fund managers. Individual investors must consider the process, philosophy, and consistency of a fund's management when selecting actively managed funds. Invest with funds that have processes and philosophies you trust, and have proven an ability to deliver better than average results over long periods of time.

Then, it is essential to remain patient when short-term results are disappointing. Years like 2011 are anomalous, and the combination of headwinds encountered by active investors in recent months is rare. Once the latest panic has passed and confidence has returned to the market, the true intrinsic values of investments made based on sound fundamental factors should benefit actively managed funds and reward investors with the patience to stay the course.

Questions or comments, please contact:

Owen Murray, CFA
omurray@horizon-advisors.com

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