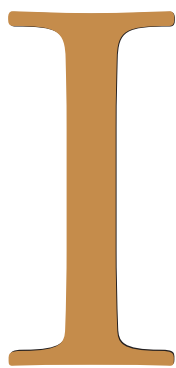


# JUDGMENT DAY

A NEW WAY TO  
CATEGORIZE AND  
EVALUATE MUTUAL  
FUNDS—AND  
THEIR MANAGERS

BY CRAIG T. CALLAHAN, DBA, AND C. THOMAS HOWARD, PHD.



**I**N THE *JOURNAL of Investment Consulting* (Winter 2005-06) and in a series of articles in *Investment Advisor* (September 2005, February 2006, and March 2006), we made the case that constraining investment managers to “boxes,” defined by market capitalization and value-growth characteristics, costs about 300 basis points per year in underperformance. We referenced other studies that found similar results. We

also showed that characteristic boxes are not asset classes and that diversifying funds among those boxes provides minimal, if any, risk reduction beyond what can be obtained by randomly selecting mutual funds.

In those articles, we discussed the distinction between value-growth and market capitalization “characteristics” and “style,” where style is the manner in which a manager analyzes, buys, and sells stocks. Our premise is that the category of “large-cap value,” for example, states nothing about how a manager selects large-cap value stocks. It simply states that a manager is constrained by characteristics.

Our research shows that categorizing and constraining managers by characteristics not only hurts performance and provides minimal risk benefits, but also provides little or no information regarding the investment strategy being pursued by a fund and its manager.

## STRATEGIES FOR MANAGING EQUITY FUNDS

We believe that the two most important pieces of information regarding an active investment manager are the investment strategy being pursued, and how consistently it is being pursued. We refer to this approach as Strategy Based Investing, or SBI. For the equity version of SBI, we have identified 10 general strategies for managing equity portfolios. (“Style” may have been a more suitable word than “strategies,” but since we believe that word has been used incorrectly as a synonym for “characteristic” for almost 20 years, we have opted to employ “strategy” instead.) The 10 equity strategies that our research categorized are:

**No. 1: Competitive Position.** Competitive Position managers seek companies with traits such as high-quality management, defensible market position, and a track record of innovation.

**No. 2: Economic Condition.** Economic Condition managers start with macro-economic forecasting and work their way down to favored industries and stocks.

**No. 3: Future Growth.** Future Growth managers invest based on the growth prospects of companies. It should be noted that they are not limited to what have traditionally been labeled “growth” and “value” stocks.

**No. 4: Valuation.** Valuation managers use financial ratios to determine stock valuations and invest in companies that are underpriced.

**No. 5: Profitability.** Profitability managers favor companies with impressive margins and/or return on equity.

**No. 6: Market Condition.** Momentum and technical analysis might be employed by Market Condition managers.

**No. 7: Social Considerations.** Social Considerations managers focus on companies that are socially responsible, ecologically aware, or invest based on religious tenets.

**No. 8: Quantitative.** Statistical and mathematical modeling are the focus of the Quantitative Strategy manager.

**No. 9: Opportunity.** Opportunity managers seek market imbalances that are driven by events such as earnings surprises.

**No. 10: Risk.** Risk managers favor companies with below-average business risk among other similar traits.

## LOOKING AT EQUITY FUNDS THROUGH STRATEGY LENSES

AthenaInvest has surveyed all open-end domestic equity mutual funds (more than 9,000 as reported by Lipper, Inc.), which, disregarding multiple share classes, covers about 2,900 unique funds. We were able to categorize 2,012 funds into one of the 10 strategies in our SBI system. The remaining funds were index funds or did not provide enough strategy information for us to categorize.

**TABLE 1: U.S. EQUITY OPEN-END FUNDS BY PRIMARY STRATEGY**

BASED ON ATHENAINVEST AND LIPPER DATA AS OF APRIL 2007 FOR 2,012 UNIQUE FUNDS

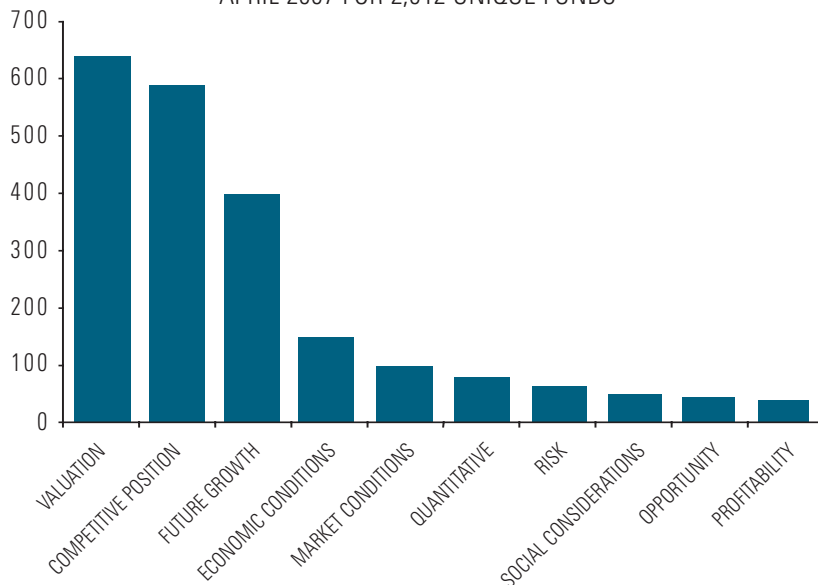


Table 1 shows the prevalence of the 10 different strategies among the funds we studied. Valuation was the most popular, practiced by 622 managers. Competitive Position and Future Growth were the second and third most popular strategies. Notice that none of the three most popular Strategies has a primary focus on the economy. They simply look for bargains, high-quality companies, or future growth, respectively.

Economic Conditions was the fourth most popular approach, but was practiced by only 5% of the managers in our sample. It is interesting that financial TV networks debate the economy 24 hours a day for entertainment purposes, but that 95% of professional managers do not focus primarily on the economy when pursuing their strategies.

Table 2 shows year-to-date, one-, three-, five-, and 10-year returns for all 10 strategies sorted by 10-year return through April 2007. Valuation stands out as being the most productive strategy over all time periods. Over the longer periods, Social Considerations, Competitive Position, Quantitative, and Market Conditions have been productive strategies as well. Year-to-date for 2007 through April, Future Growth and Market Conditions have produced good returns. The Opportunity, Future

TABLE 2: TOP PERFORMING STRATEGIES OVER TIME

	COUNT	YTD	1YR	3YR	5YR	10YR
MARKET CONDITIONS	84	6.13	9.47	13.57	9.81	10.20
VALUATION	622	5.65	12.00	13.90	10.10	10.09
COMPETITIVE POSITION	564	6.15	9.62	12.81	9.29	9.57
SOCIAL CONSIDERATIONS	41	5.66	9.37	12.40	8.57	8.98
QUANTITATIVE	44	5.59	9.43	12.69	8.48	8.91
PROFITABILITY	46	6.05	9.67	12.12	8.88	8.78
RISK	53	5.51	10.70	12.34	8.51	8.71
ECONOMIC CONDITIONS	110	5.93	9.07	12.75	9.19	8.38
FUTURE GROWTH	408	6.13	8.02	11.59	7.71	8.37
OPPORTUNITY	40	5.21	9.38	11.94	8.58	8.24
TOTAL/AVERAGE	2,012	5.92	10.01	12.87	9.15	9.35

Source: AthenaInvest and Lipper Inc. Fund returns are net of management and 12b-1 fees, but not sales, load, or other charges. The number of funds in each sample declines with the length of the time period.

assessing growth. Are there so many managers pursuing these strategies that, due to competitive forces, the individual strategy's benefits are negated? Perhaps the managers in the lagging strategies have been characteristic constrained? Based on earlier studies, the data is clear that characteristic drift and performance are inversely related. It should be noted that the results reported in the returns table are averages. In each category, there are managers who are strategy consistent and, as a result, have produced strong results.

The two most **important** pieces of information regarding an active **investment manager** are the **investment strategy** being pursued, and how **consistently** it is being pursued.

Growth, Economic Conditions, and Profitability Strategies have produced poor relative returns, according to our study.

These latter results lead to some interesting speculation. Are these not productive strategies? Are they intuitively appealing but perhaps not useful approaches? Or are their disappointing results unique to specific time periods we examined? Perhaps in different economic and financial settings they might be more successful.

Some might argue that the differences among strategy returns are simply the result of differences in risk or due to other effects. We adjusted returns for these factors, and the relative performance among the strategies hardly changed. Thus, the performance differences among strategies are determined by factors above and beyond risk and other effects.

Alternately, are these potentially productive strategies, but the managers using them are not good at applying them? For example, perhaps Future Growth is a potentially productive strategy, but managers are not good at

### PRIMARY AND SECONDARY STRATEGIES

In addition to a primary strategy, we identified managers' secondary strategy. For example, let's review two Competitive Position managers, A and B. They both screen for and favor what they view as high-quality companies. Manager A selects the ones with the highest potential growth (Future Growth) while manager B favors the cheap ones (Valuation). According to our study, manager A would be a Competitive Position primary strategy manager with a Future Growth secondary strategy, whereas manager B employs a Valuation secondary strategy to complement his Competitive Position primary strategy.

Table 3 shows the top five performing primary strategies on the vertical column, and the top five performing secondary strategies horizontally. These fields represent superior performing combinations as measured by three-year risk-adjusted returns ending April 2007. The table entries are the number of managers pursuing these strategy combinations.

Let's look at performance in another way. Table 4 shows

**TABLE 3: MANAGERS WHO PUT IT ALL TOGETHER**

THE NUMBER OF MANAGERS WHO ARE EMPLOYING AS THEIR PRIMARY STRATEGY THE TOP PERFORMING PRIMARY STRATEGY AMONG THE TOP FIVE, AND WHO ARE EMPLOYING AS THEIR SECONDARY STRATEGY THE SECOND TOP PERFORMING STRATEGY

PRIMARY	SECONDARY QUANTITATIVE	OPPORTUNITY	RISK	MARKET CONDITIONS	VALUATION
VALUATION	20	32	12	51	--
QUANTITATIVE	--	--	4	3	6
OPPORTUNITY	7	--	6	1	13
RISK	2	3	--	2	6
MARKET CONDITIONS	5	1	1	--	9

Strategies ranked by three-year risk-adjusted returns for the period ending April 30, 2007  
**Source:** Athenainvest and Lipper, April 2007.

**TABLE 4: MANAGERS WHO CAN'T GET IT TOGETHER**

THE NUMBER OF MANAGERS WHO USE THE MOST UNPRODUCTIVE STRATEGY COMBINATIONS: USING THE WORST RETURNING STRATEGIES AS THEIR PRIMARY AND SECONDARY STRATEGIES

PRIMARY	SECONDARY ECONOMIC CONDITIONS	COMPETITIVE POSITION	PROFITABILITY	FUTURE GROWTH	SOCIAL CONSIDERATIONS
SOCIAL CONSIDERATIONS	7	2	--	6	--
ECONOMIC CONDITIONS	34	--	3	19	5
COMPETITIVE POSITION	--	127	38	171	4
PROFITABILITY	7	6	--	7	1
FUTURE GROWTH	144	27	18	--	3

Strategies ranked by three year risk-adjusted returns for the period ending April 30, 2007  
**Source:** Athenainvest and Lipper, April 2007.

the bottom performing primary and secondary strategies over the same three-year period ending April 2007. It is interesting to note that the combination of Future Growth and Competitive Position in either primary-secondary sequence is not productive, yet it is used by more than 300 managers.

also developed an easy-to-use application that allows advisers to categorize, restructure an existing portfolio, and track performance using SBI concepts.

In the context of our SBI system, managers are no longer constrained by characteristics and are free to be strategy consistent in the pursuit of alpha. **IA**



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It is also apparent that fewer managers, in general, use the most productive combinations in Table 3 while many more managers in Table 4 use unproductive strategy combinations.

**A NEW FUND EVALUATION TOOL**

By using SBI, it is possible to categorize managers in a way that we believe allows for the formation of meaningful peer groups. Managers can be evaluated by strategy to see who is good at a strategy and who isn't. Strategy consistency can be measured, which leads to adult portfolio management rather than playpen management. "Adult portfolio management" occurs when managers state their strategy and are expected to stick to it. Our continuing SBI research reveals that strategy optimization and consistency lead to superior performance in the range of the 300 basis points, which we first revealed in our broad strategy consistency research.

We believe in the strategy based investing approach, in which managers are no longer constrained by characteristics and are free to be strategy consistent in the pursuit of alpha. We have