

Myths and Realities of Fund Management

Philip Winder



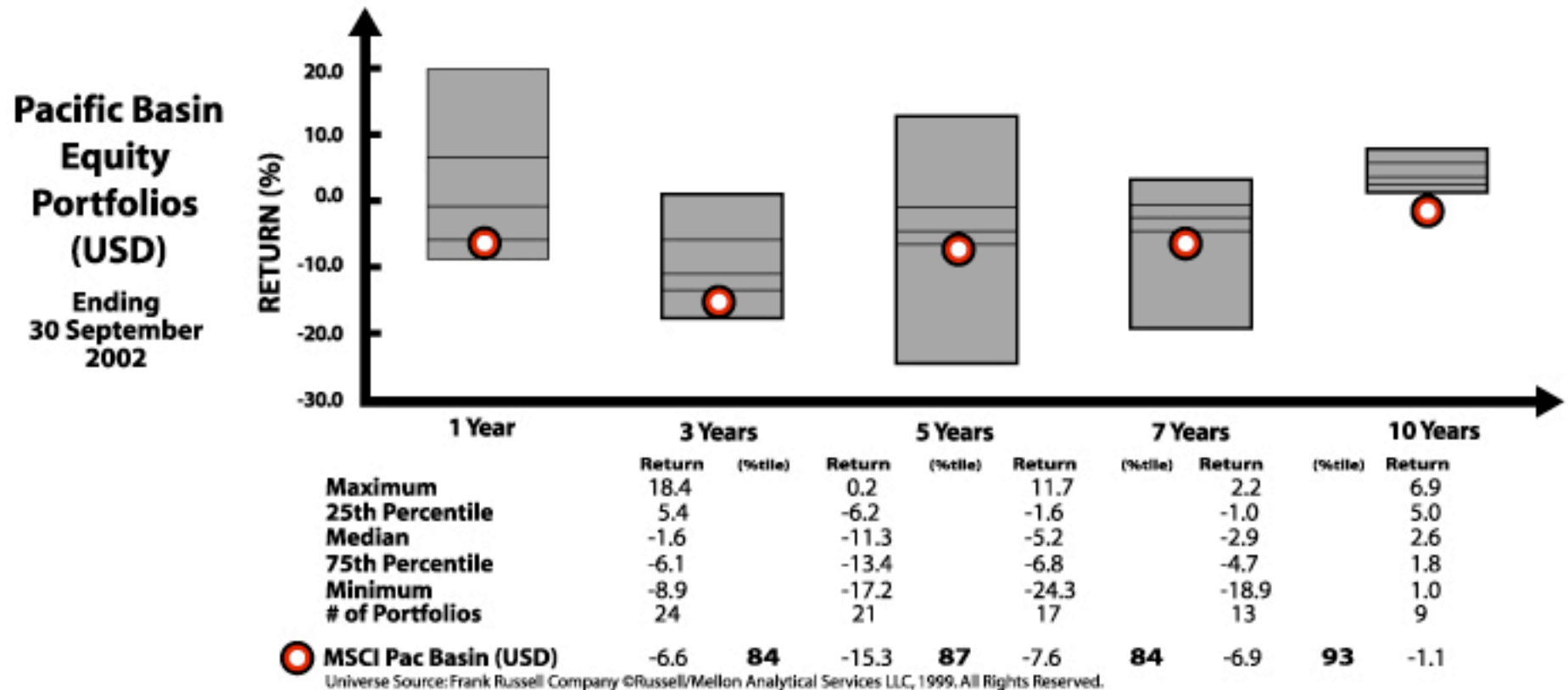
POLYGON

Investment Management

Does Stock Selection Add Value?

The good news:

In inefficient markets active managers tend to outperform





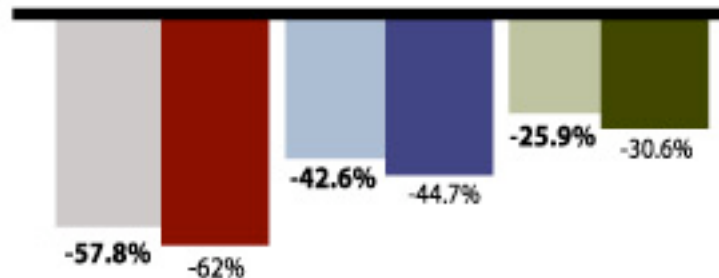
The Bad News

- **Over time 70% to 80% of fund managers underperform in the major markets**
- **Information is transmitted simultaneously to market participants**
- **Quality of research is often low**
- **Tracking benchmarks results in closet indexation or over diversification**
- **Transaction costs penalize managers who trade extensively**

Performance of Active US Equity Managers

The near term....

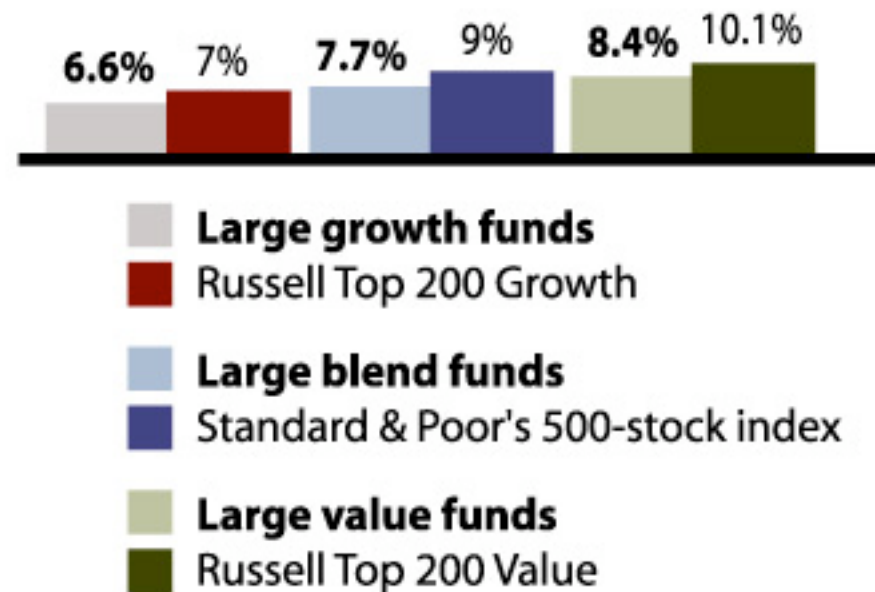
Bear-market return, cumulative
(8/2000 through 10/2002)



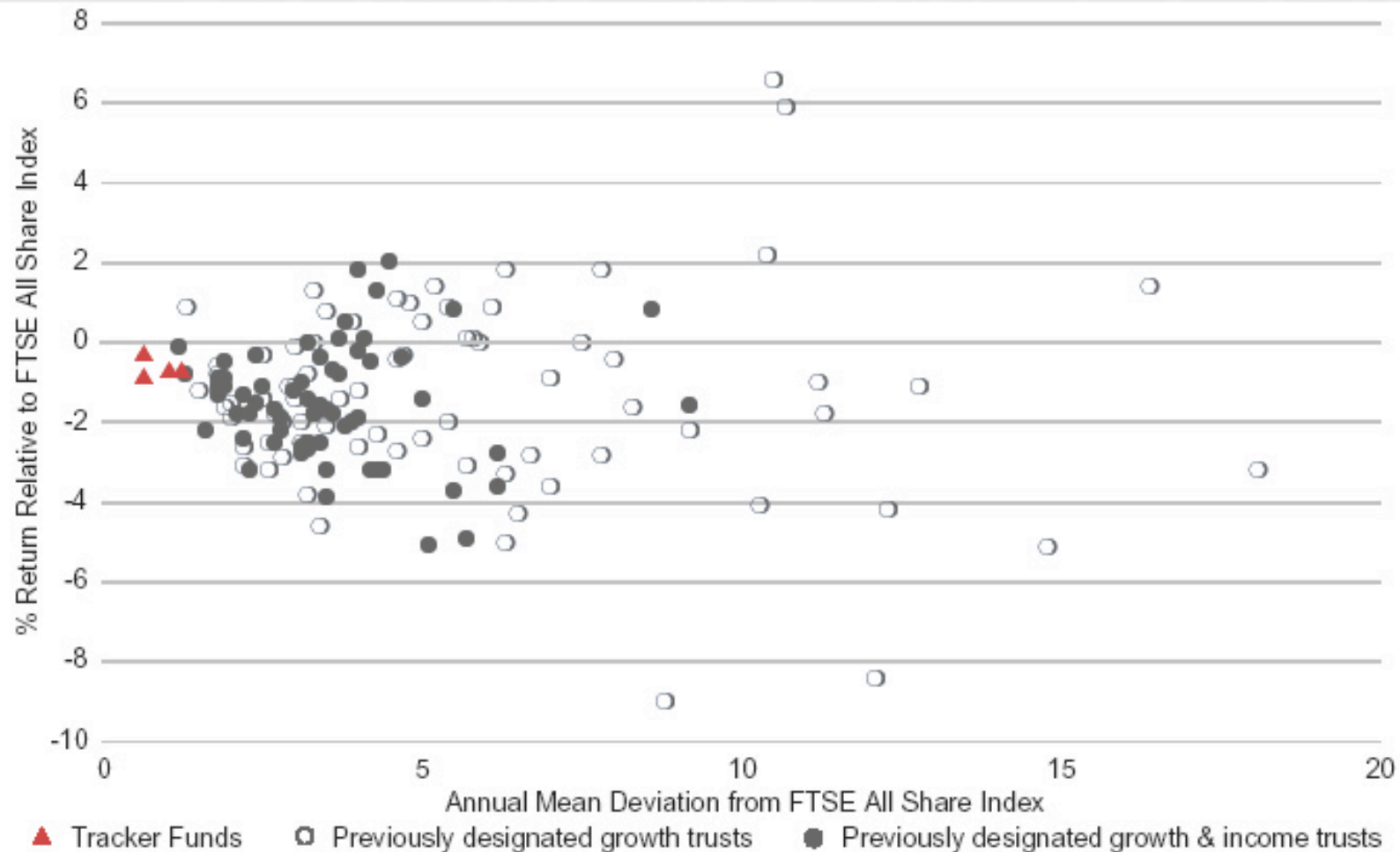
Source: Morningstar

The long term....

10 year return, annualized
(period ending 10/2002)



10 Years Annualized Returns and Volatility

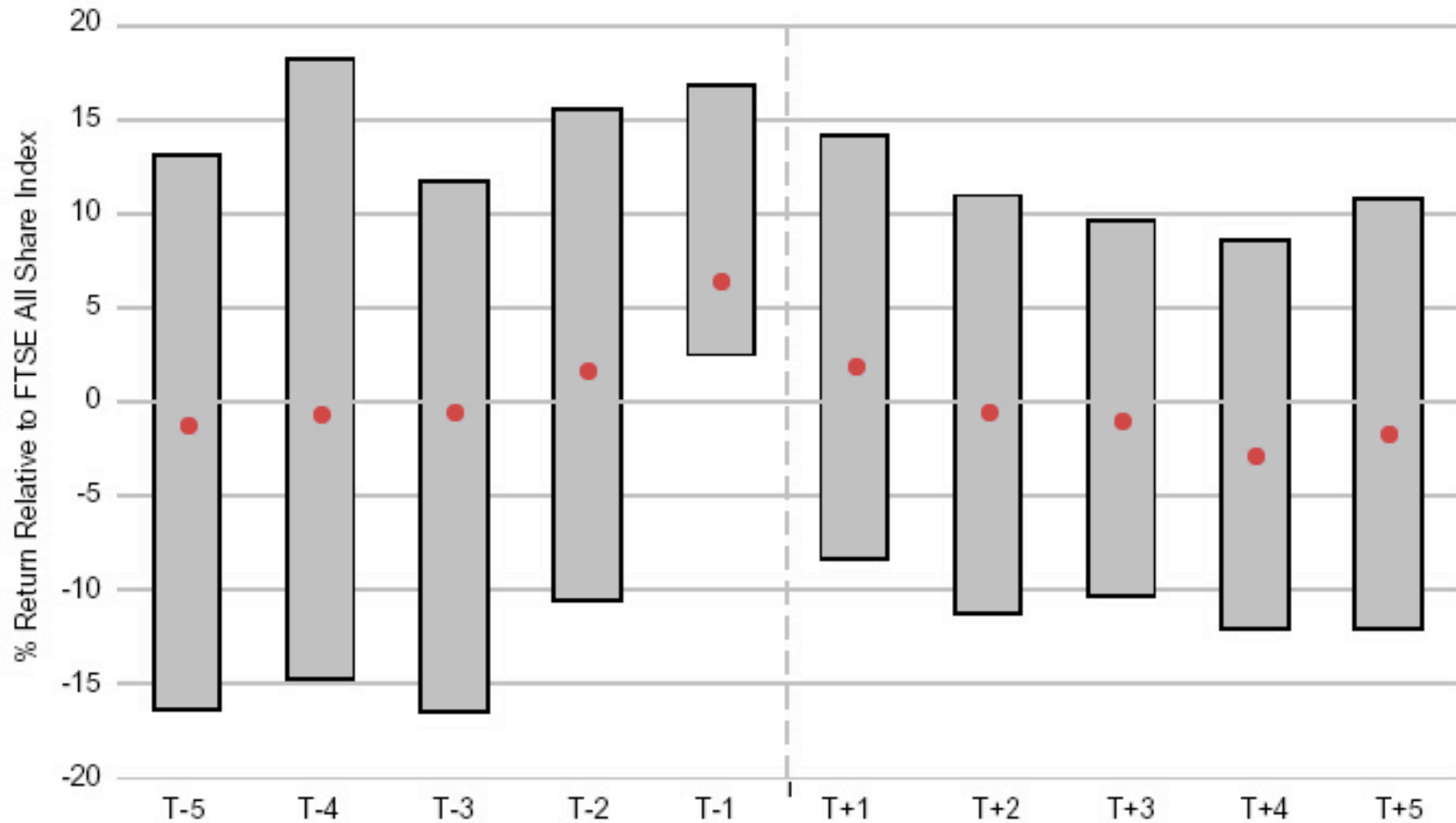


Source: WM Research and Consultancy

Can Managers That Will Outperform Be Identified?

- **Statistically it is hard to predict which managers will add value in the future**
- **Some indications of mean reversion**
- **Outperformance often due to style bias or asset allocation rather than stock selection**
- **Persistency of performance appears to be more common amongst hedge funds**

Annual Performance of Top Quartile Trusts

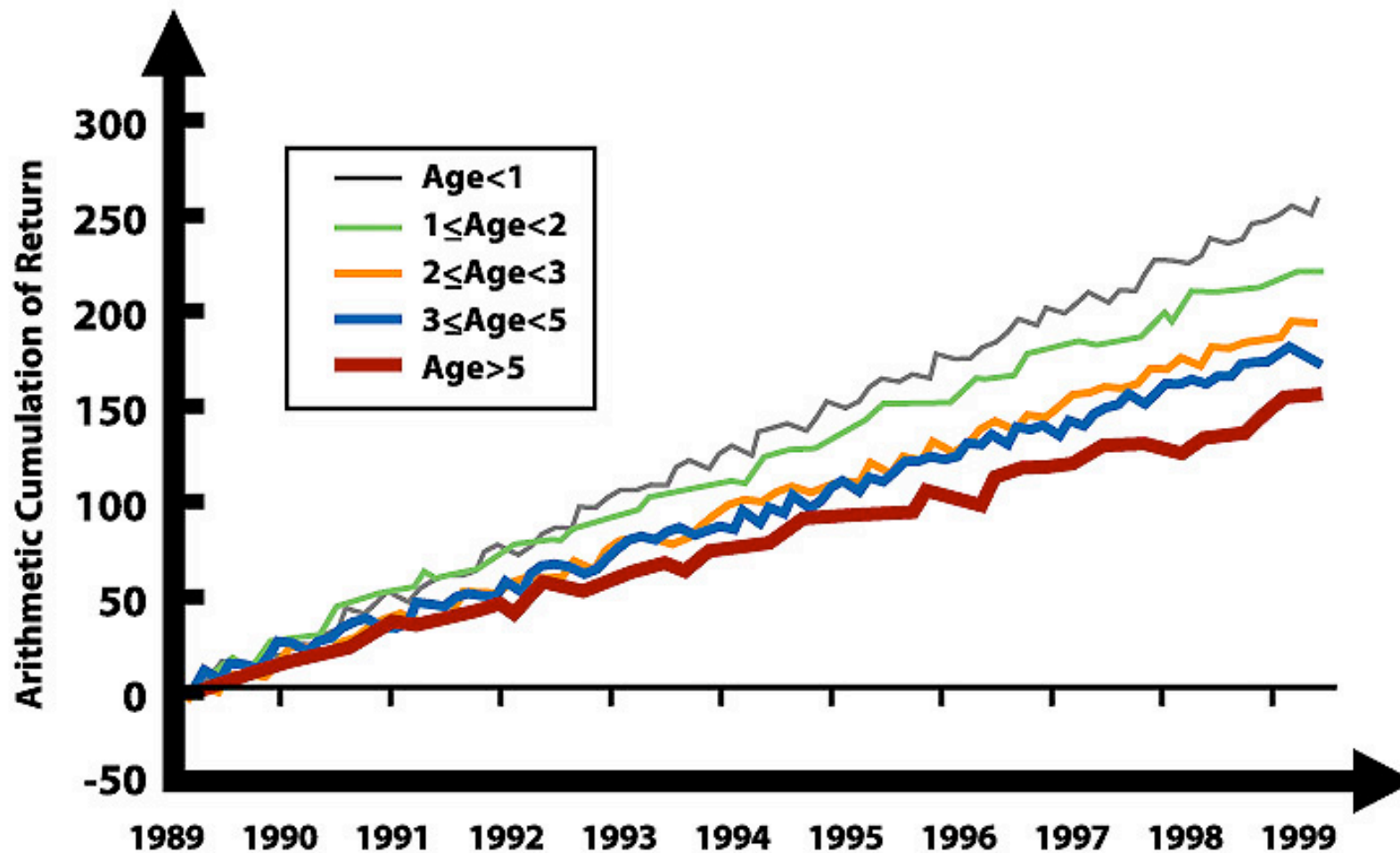


Source: WM Research and Consultancy

Newer, Smaller Managers Tend To Outperform

- Fewer bureaucratic constraints
- More entrepreneurial
- Less market impact because trading in smaller lots
- Faster to react to market developments
- Self selecting universe

Performance of Funds by Age



Source: Morgan Stanley

Do Locally Based Managers Add Value?

- **Often too close to the market**
- **Less objective**
- **Information flows increasingly globalized**
- **Evidence provides mixed picture**

Does Economic Research Add Value?

- **Quality of analytic input**
- **Leads and lags are unpredictable**
- **Markets react differently to different stimuli at different times**
- **Over the short term the relationship between macro economics and markets is difficult to determine**



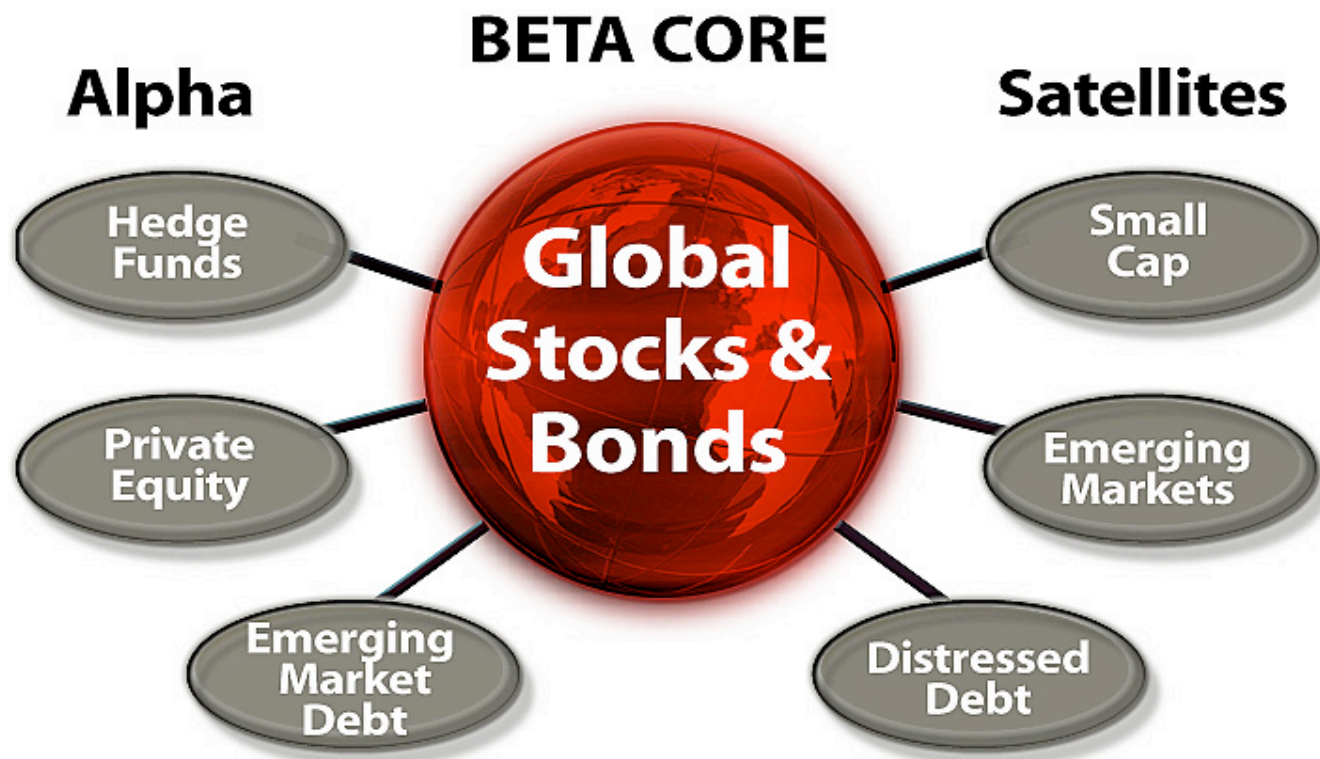
Realities

- **Asset allocation is key determinant of performance**
- **Given high correlations within markets stock selection not critical for conventional, diversified portfolios**
- **Risk budget should be allocated to exploit inefficiencies in the marketplace**
- **Buy and hold strategies limit transaction costs**

Solutions

- **Invest intellectual capital in top down decision making**
- **Exposure to major markets should be passive**
- **Depending on appetite for risk, allocations to smaller, less efficient markets should be considered**
- **Look for small, motivated managers with institutional characteristics**

Core Satellite Strategy



- High beta core
- Alpha generating Satellites

Contact Information

For further information, please contact:

B. Philip Winder

Managing Director

Princeton, NJ USA

Tel 609-921-2445

Mobile 609-933-5969

Email: bpw@polygonim.com

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