Active Fund Strategies Investment Philosophy and Process

written by Active Fund Strategies President Jeff McTague

> *"In terms of making a positive impact on my business, Jeff McTague's philosophy and process is the single best presentation I have seen in my 22 years as a financial consultant."*
> — JoLynn Free, First Vice President - RBC Dain Wealth Management, Austin TX

Setting the Stage

Study Shows Gen Y is Highly Proactive and is Most Likely to Embrace Do-It-Yourself Investing (BUSINESS WIRE 10/06/09)

"In the wake of the past year's economic setbacks, many investors across all generations are taking new measures to more actively manage their investments." Said Chris Moloney, Scottrade's chief marketing officer. And 40% of the Gen Y generation is making all investment decisions on their own.

Check out our PowerPoint presentation

Did you know:

- 70% of all mutual fund dollars are invested in no-load funds,
- 42 of the 50 largest funds are No-Load,
- and if not for American Funds, only 1 of the largest 50 funds would be a load fund.

Why would so many investors think they can go it alone? Why would they think investing is a Do-It-Yourself Process? We think the answer is quite simple:

1. Trusted advisors failed to protect them from the devastation of the last two large losses in the market,

2. Additionally, do-it-yourselfers feel that financial consultants bring very little to the table. At least, not enough to justify the fee,

3. Investors have access to much of the information previously only available to professionals,

4. In spite of their constant failure, the financial media offers unending advice,

5. Do-It-Yourselfers select funds based almost entirely on past performance, and there is no shortage of media help in selecting these funds.

6. They are then taught to put the portfolio in a dresser drawer —under the socks— and leave it there.

7. Many investors have given up on the idea of beating the market altogether, as evidenced by the tremendous growth in index funds and exchange-traded funds. And if investors are going to settle for the performance of an index fund, they sure don't need the assistance of an investment professional.

So, what is a financial consultant to do?

the Active Fund Strategies Philosophy

Twenty years ago, using the wealth of historical fund data available, we began to develop a system to respond to this challenge. We have presented this system to thousands of financial consultants around the country. Many of them claim that it changed their whole way of thinking.

> *"I have been in the investment business for over 17 years and [Jeff's] presentation and methodology has been by far the best I have seen.* ***<u>It should be mandatory</u>*** *that EVERYONE in the investment industry be involved with his presentations and process."*
> — SM, Financial Consultant - Richmond VA

Capturing Prospects and Solidifying Client Relationships

Changing the mind of the investor requires creating doubt about the tenants of the accepted philosophy and process.

Tenant #1	Successful mutual fund selection revolves around choosing funds with a strong record of previous performance.
Your task	*Prove that past performance is a miserable predictor of future fund performance.*

Tenant #2	The financial media provides quality assistance in the fund selection process.
Your task	*Prove that the financial media is not an investor's trusted guide to selecting mutual funds. Expose the historical failure of the mutual fund rankings and recommendations of the financial media.*

Tenant #3	A portfolio of no-load, low-cost index funds or ETFs will outperform a portfolio of actively-managed funds, because active-fund managers cannot beat the index.
Your task	*Prove that most actively-managed funds do indeed beat the index, and on a very consistent basis.*

Tenant #4	A successful mutual fund portfolio requires little active management; but rather, it should be tucked away as part of a "buy and hold" investment strategy.
Your task	*Prove that a successful mutual fund portfolio requires ongoing, time-consuming, active management. Prove that a "buy & forget" management strategy is not in the best interest of the portfolio's safe growth.*

With proof in hand that . . .

1. past performance is no way to select funds
2. the financial media is not an investor's trusted fund selection guide
3. active fund managers actually DO beat their index, and that . . .
4. successful fund investing requires ongoing, time consuming, active management

. . . prospects and clients alike should be convinced that they would be foolish to go it alone; instead, they should seek out an investment professional to guide their financial future. But why choose you?

Why Should Investors Choose You?

Chances are that you have never entered a beauty contest in your life, but that is the reality of the business you are in. We say this because it is our experience that prospects choose you for one of only two reasons:

- they like you . . . OR . . . don't!
- they trust you . . . OR . . .don't!

When we ask financial consultants why they get picked, we never hear any objective, concrete, provable reasons for their selection. Don't believe us? Try answering these questions:

- Is long-term past performance a good fund selection tool?
  - Can you prove it?
- What percent of actively-managed funds beat their index?
  - Can you prove it?
- What is the relationship between fund size and performance?
  - Can you prove it?

Of course, the financial service industry has an unending supply of questions like these, to which you have a ready answer to most of them. But unless you can prove it, your answer is simply your opinion. How many advisors work in your marketplace? How many opinions are there?

That is why a prospect's entire basis for choosing a financial consultant is subjective. No matter how hard you prepare to be the best financial consultant you can be, the prospect's selection of you — or someone else — is based on feel, on emotions. In his book the *Little Red Book of Selling*, Jeffrey Gitomer says "If they like you, and they believe you, and they trust you, and they have confidence in you, then they may buy from you." We agree with Jeffrey, but it does not need to be that way in your chosen profession.

What would it do to the competition for clients, if, while your competitors offer a program supported by "trust me," you presented an investment philosophy and portfolio-managing process supported entirely with graphic, factual proof? The system at Active Fund Strategies provides you with everything necessary to shape and explain your investment philosophy, with proofs about why you do what you do . . . and, most importantly, why it works. It provides the prospect with clear concrete reasons to select you as the steward of his/her financial future.

Build your book by converting more prospects to clients and creating stronger relationships with your existing clientele. Convince them that a long-term successful investment program requires the active, diligent management of an investment professional. Someone like you!

the 7-Step Process

Step #1 — Past Performance is No Way to Select Funds
After reviewing decades of mutual fund performance, noted financial markets academic and Nobel Prize winner William Sharpe concluded that "past performance is a thin reed for how to predict future performance." Our research studies reach the same conclusion. Our reports are graphic and colorful. Financial consultants claim that the color-scheme concept that we use with our past performance charts has been instrumental in convincing investors that following past performance is counter productive. Convincing prospects and clients alike that selecting funds based on past performance is most often fools gold is a critical first step in the presentation of the investment philosophy and process.

Step #2 — The Financial Media is Not an Investor's Trusted Fund Selection Guide
There is no shortage of mutual fund opinion and recommendation from the financial media — TV, radio and print; however, when we look for reviews of those opinions and recommendations, we cannot find any. The absence of such reviews says volumes. After all, if the financial media's mutual fund recommendation track record was impressive, they would be shouting it from the rooftops. We have conducted exhaustive reviews of the media's fund recommendations for 15 years. The theme of every report is the same. When it comes to mutual fund recommendations, the financial media has a very poor track record.

Step #3 — Active Fund Managers Actually DO Beat Their Index
With the aid of the financial media, notably Jonathan Clement, with an assist from John Bogle, many investors have been convinced that actively managed funds just cannot beat the index. To paraphrase a famous quote, "If you can't beat 'em, buy 'em!" In the last five years alone, the number of index funds has doubled and exchange-traded funds now number over 1,700. Our research proves this accepted reality is just not true. Purchasing index funds or ETFs is settling for average, while many actively-managed funds do beat their index.

Step #4 — Asset Allocation

We have a system for selecting funds. But before we detail the system to you, first we would like to discuss a major tenant to most successful mutual fund portfolios — asset allocation. Whether the allocation is meant to be conservative or aggressive, actively or passively managed, we feel strongly that until you and your client have settled on the proper allocation, discussing specific funds is a waste of time.

Step #5 — Fund Selection Process

We have a system for selecting funds that is structured, provable, monitored and managed. Many years ago, after our research convinced us that past performance was not a successful fund selection tool, we had to ask, "If past performance cannot help me find successful future performance, what can?" We wondered if successful funds had specific traits in common, and in reverse, did unsuccessful funds have a common thread? If they did, maybe those traits, clustered together, could increase the odds of selecting the right funds for the portfolio. Our research identified 11 common traits of successful and unsuccessful funds. Employing these traits in the fund selection process has significantly increased our mutual fund selection success. The 11 traits are:

1. Size (assets under management)
2. Management Style
3. Manager Tenure
4. Expense Ratio
5. Turnover
6. Standard Deviation (3-year or 5-year)
7. Beta (3-year or 5-year)
8. Alpha (3-year or 5-year)
9. R-Squared (3-year or 5-year)
10. Return in the Last Bull Market
11. Return in the Last Bear Market

Step #6 — The Report Card System

For 21 years, since 1997, we have used these traits to create report cards on each mutual fund, tallying the quartile rankings of each fund in these 11 separate investment category attributes. The 2018 version contains 6,066 funds in 94 categories. These Report Cards can be used for a variety of purposes —

- as a thumbnail sketch of any fund
- as a quick assessment tool for any fund that a prospect or client may mention
- as part of a complete portfolio review
- as the basis for a mutual fund focus list
- as a second opinion of the funds from an existing focus list

> *"This is a must program for anyone who uses managed products in their business."*
> *— Fred Lipp – Wells Fargo Advisors, Eustis FL*

Step #7 — Monitoring and Managing the Process

Once the portfolio's allocations and fund selections are complete, it is time to begin the function which earns an investment professional his/her money — actively monitoring and managing the process. Important decisions will be made all along the way:

- Lump Sum or Dollar-Cost Average the investment?
- How to invest additional sums?
- What to do with a specific fund if it . . .
  - underperforms the market?
  - underperforms its peers?
  - replaces its manager?
  - merges with another fund?
  - is purchased by another fund family?
  - substantially grows in size?
  - raises its expenses?
  - increases its turnover?
  - changes its risk tolerances — standard deviation, beta, alpha, r-squared?
  - changes investment category?
  - changes investment objective?
  - increases its concentration in specific holdings?
- Rebalance the portfolio?
  - How often?

Lump Sum or Dollar-Cost Average?

We have conducted exhaustive studies comparing the all-at-once investment of a lump sum of money with the slower, more conservative method of spooning fixed portions of the lump into the market at fixed intervals. The research shows that investing the lump sum all at once is superior to dollar-cost averaging 62% of the time, and of all the dollar-cost averaging options, investing the sum over six months is clearly the best option.

Underperforms the Market?
All funds, at one time or another, underperform the market as well as their specific investment category average. In fact, one of the only true things an investment professional can tell a prospect or client about any fund is that it will go down in value. It is not a question of "if," but simply a question of "when and for how long?" But how much is too much and how long is too long? We do not advise replacing a fund because it performed poorly against its peer group in any given year. However, two consecutive years of performing in the lower half of its peer group demands attention. Should the fund under-perform its designated investment category average through the second quarter of a third consecutive year, we strongly suggest replacing the fund.

Replaces a Manager?
If the manager responsible for the fund's recent performance history departs the fund, we always suggest replacing the fund with another fund from the same category. Our research suggests that, most often, fund performance suffers from the departure of its decision maker.

Merges with Another Fund?
If the merger involves the *other* fund gaining control by virtue of the newly created fund's name, stated fund objective or surviving manager, we would replace the fund with a fund from the same investment category.

Is Purchased by Another Fund Family?
Having new parents, in and of itself, should not cause a fund replacement, but it does place the fund on a shorter leash. Changes to the fund's structure, management or stated objective should be met with a large degree of skepticism. Additionally, changes in the fund's objective will adversely affect the portfolio's allocation balance. The portfolio will need to be brought back into balance by replacing some part of the portfolio. The most conservative and maybe the most comfortable fund to replace is the fund with the newly acquired parents.

Grows in Assets Substantially?
Does fund performance suffer as the fund grows larger? The logical answer is "Yes!" They say speed kills! Well, when it comes to mutual funds, size can kill too. The best-performing funds naturally become the larger ones. That is mostly because the average investor is attracted to last year's winners and shuns last year's losers. We have long felt that the "Five-Ten" rule instituted by the Investment Company Act, which restricts fund holdings, forces larger funds into owning so many different issues that they could, at best, provide average returns. It is tough to beat the market if you own the market.

To counter this belief, larger funds claim that their clout allows them more access to tomorrow's top new companies through IPO purchases. They also claim their size provides greater funding to hire more and better analysts. They claim that more analysts allow them to find more hidden performers. While these statements may be true, larger funds still face the problem of trying to purchase and subsequently liquidate these gems without artificially moving the market up while completing the "buy" or moving the market down while completing the "sell." This problem is not an issue in the bond market, but it is in the equity market, and the small and mid-cap categories feel it first.

Raises Its Expenses?

Our research suggests that higher expenses consistently equal lower returns. If a fund raises its expense ratio substantially, replace the fund with a fund from the same category.

Increases Its Turnover?

Our research suggests that higher turnover consistently equals lower returns. While a one-time significant increase in turnover is not a cause for alarm, a consistent change in fund turnover suggests a fundamental change in fund philosophy. If high turnover persists, replace the fund with another fund from the same investment category.

Changes Its Risk Tolerance — Standard Deviation, Beta, Alpha, R-Squared?

A departure in risk tolerance from the established risk profile of a fund attracts attention. Increases in beta and standard deviation and decreases in R-squared may suggest a fundamental change in fund philosophy. A conversation with the management of the fund is in order. If not satisfied with the explanation for the change, replace the fund.

Changes Investment Category or Investment Objective?

It is fine for a fund to change its investment category. Maybe management has changed the investment direction of the fund, or maybe they simply think the change is necessary to more accurately reflect the investment objective of the fund. However, a change in investment objective at the fund alters the integrity of the overall allocation of the portfolio, and it needs addressed. The allocation needs to be maintained, or why allocate in the first place. Additionally, if the change is a departure from the fund's stated objective, why the change? Will the presumably successful past performance of the fund in one category successfully carry over to a whole new category? We would not continue holding a fund which truly changed its category or objective.

Increases Its Concentration in Specific Holdings?

There is nothing wrong with a fund making the decision to own as much of a particular stock as regulation allows, but since this increased holding will have a more significant impact on the fund's performance, we want to be conscious of such a decision. Too many dollars tied up in too few stocks can eliminate the major attribute of fund investing — diversification. On the other hand, too many holdings compromise a fund's ability to outperform its benchmark. We advise replacing a fund if it is a core part of the portfolio and its top ten holdings represent more than 60% of the fund's total assets. However, owning a fund with heavy concentration in a few securities can provide significant bang for the buck, but again, we would only consider such a fund as a non-core holding.

Rebalance the portfolio?

We absolutely believe in rebalancing the portfolio; otherwise, what was the purpose of the allocation process. We find that, functionally speaking, the best rebalancing takes place in January.