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DEEP ROOTED THOUGHTS

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eadline makers or money makers?

It is always tempting to believe that the grass is greener on the other side of the fence. Investors who succumb to this temptation chase the latest tip or invest with the manager who is touted by the media as being the best of the best. Oak Wealth Advisors believes that a disciplined strategy that reflects the individual needs of our clients and utilizes low cost passive investments is a superior approach to investing with the “best” ranked stock pickers. To support our view, let’s take a look at how green the grass is on the other side.

We will start with the most famous and most respected investor of our time. Warren Buffett, the Oracle of Omaha, has served as CEO of Berkshire Hathaway for decades and has made millions of dollars for investors who invested with him initially back in the late 1960’s and early 1970’s. Now 81, Buffett has a huge following for his folksy quotes and long-term success. While he should be praised for suggesting that most people are best served by owning low-cost index mutual funds, he nonetheless continues to operate his business by making opportunistic acquisitions in the hopes of producing market beating returns. His company is essentially an investment bank that owns a number of private businesses and publicly traded securities. It has some operational advantages that mutual funds do not enjoy and therefore could produce superior returns assuming Buffett and his team do a great job managing their portfolio of investments.

Over the past three years, the S&P 500 stock index has produced a cumulative return of 39.3% (essentially the entire return came in 2009 and 2010 as the index was flat for 2011). Shares of Berkshire Hathaway are up 18.8% over the same period. That is a negative gap of over 20% for the three year period. Admittedly, the long-term track record of Berkshire Hathaway is very good, but if you were implementing new investments in the past three years, Berkshire Hathaway would have dragged down your returns.

Next, we consider another investment manager who was heralded in the mid-2000’s for putting together a string of fifteen straight years of outperforming the S&P 500 index with his stock mutual fund. Bill Miller, the head of Legg Mason Value Trust Fund, was trumpeted so loudly in 2005 for his fifteen year run that he was hard to miss him. However, if you were opening a new account in 2006, you would have been better off having never heard his name.

From 2006 through 2011, his mutual fund has performed so poorly that the fund which once held over \$21 billion dollars has been diminished to \$2.8 billion due to both performance and investor withdrawals. His fund’s performance ranks in the bottom 1% of equity mutual funds for the five years ended 2011. Not surprisingly, the parent company that owns his mutual fund stripped him of management duties at the fund as of the end of 2011.

Buffett and Miller are two of the most highly regarded stock investors of the last several decades. Unfortunately, even the best managers can fail with no guarantee that their superior performance will return.

More recently, Morningstar Inc. selected Bruce Berkowitz of the Fairholme Fund as the Domestic Stock Manager of the Decade in 2010. If you saw the magazine covers and headlines, you would have felt very comfortable investing with Berkowitz in 2011 given his stellar track record. But you must keep in mind the award was for **past** performance. The fund lost over 32% in 2011 which led to its ranking in the bottom 1% of all stock mutual funds. To make matters worse, the underperformance has led Berkowitz's partner and less well known co-manager to resign from the firm. With his departure and the concentrated bets the fund is making, you had better have a very large risk tolerance to invest in the Fairholme Fund on a going-forward basis.

Maybe the people with hundred-million dollar accounts who build their portfolios with multiple consultants and a myriad of private investments have the greater advantage. Two of the most heralded investment strategists coming out of the recession who work with the highest net-worth families are John Paulson and Meredith Whitney. Both were lauded for the accuracy of their research regarding the issues with the mortgage and consumer credit markets. If you had invested with them back in 2007-2009, you would have seen large portfolio gains when the majority of the investment markets were declining. But chasing winners has a way of leading to regret even with the largest of accounts.

Whitney, whose firm specializes in valuation and strategic portfolio positioning, went on the television show *60 Minutes* in December of 2010 to warn the investing public that municipal bonds were headed for disaster in 2011. In fact, she went so far as to specify that the municipal bond market would suffer "50 to 100 sizeable defaults" worth "hundreds of billions of dollars" and the carnage would be evident "within 12 months." She backed up her forecast with thick research documents. In reviewing the results from 2011, we find that the value of the municipal bonds that entered payment default in 2011 was \$1.6 billion. That comes in at less than half of the 2010 defaults which totaled \$4.25 billion, and quite a bit short of the hundreds of billions Whitney's research had forecast. In fact, most intermediate-term municipal bond investors earned returns around 10% in 2011 as municipal bonds were one of the best performing asset classes. The unfortunate result from Whitney's warning is that many investors who should have exposure to municipal bonds in their portfolios avoided them last year.

John Paulson runs a handful of hedge funds that rose to fame after betting heavily against the mortgage market in 2007 and 2008. His successful investments that returned close to 600% made him the envy of hedge fund managers around the world and attracted many new well-heeled investors. Unfortunately for the newer investors, Paulson may be the most glaring example of how hard it is to repeat significant prior outperformance as his primary hedge fund had lost over 40% of its value between January and November of 2011.

While it may appear smarter to invest money with the anointed "best" money managers in the world, the long-term results continue to favor the less obvious approach of broad market diversification, disciplined portfolio rebalancing, and focus on total costs and tax efficiency. It is human nature to want to invest with the "winners." However, history continues to remind us that it is impossible to accurately predict which money managers will outperform in the future based on their prior performance.

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