Laurus MONTHLY UPDATE

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"[…] more thoughtful decision-making will lead to better overall results, and more thoughtful decision-making can be encouraged by evaluating decisions on how well they were made rather than on outcome."

-- Robert Rubin, Former US Treasury Secretary

We were recently sent a comment from a mutual fund company discussing returns for their small cap product. Apparently the manager had underperformed the index by more than 1,000 basis points over the past year. The fund company framed its marketing piece around the fact that one year is short term, and not a reflection of the manager's ability to deliver results over time.

We humbly disagree. True, any manager can underperform over a short period like a year. However the magnitude of the loss in this instance is more likely to reflect the quality of investment process used by the manager and not, as the fund company asserts, a short term aberration. Underperformance against the small cap index is more likely to occur when commodity prices are rising (given its excessive weighting of commodity stocks), but underperforming their peer group by an excessive amount gives one reason to question process.

Investing in smaller capitalization companies has its drawbacks, the largest of which is the considerable amount of work required to understand each investment and its management's capability. Unlike large capitalization portfolios that can take advantage of sector momentum – due largely to underlying liquidity – small cap portfolios require broad diversification. Like the pistons in a car engine, diversification allows individual holdings to rise and fall at various times, ensuring the overall portfolio remains relatively stable.

While a portfolio manager can opportunistically overweight a specific type of security to generate outperformance, if he is unable or unwilling to exit the positions this bias could be disastrous to client performance. For example, a small cap portfolio heavily biased to energy would have enjoyed tremendous success in certain periods over the past four years, but over the timeframe as a whole would have underperformed given that the energy sector was flat for the four year period ending December 2014.

Investors have regularly asked us about a particular competitor portfolio that has fared exceedingly well over the past five years, causing us to look deeper into the holdings to better understand causation. Over 75% of that portfolio was held in healthcare and technology stocks, which have performed exceedingly well over the five year period. In fact, if one had just purchased the index weightings in these two sectors the performance would far exceed the manager performance.

In both cases discussed above, the respective portfolio manager has taken a large bet – one has worked out, the other hasn't. The question remains, should the buyer invest in either?

Contrary to most investors' beliefs, we live in an inefficient world; full disclosure is sorely lacking, opinion is readily substituted for fact, and fear or greed drives market prices to excess. As portfolio performance can't be easily predicted many "experts" suggest investors buy low cost exchange-traded or index funds. As we've proven over many years in small cap investing, investors can be rewarded by focusing on a portfolio manager's process (rather than performance).

Essential to a strong process is a willingness for hard work – a thorough fundamental analysis of a business's value proposition and potential for long term growth. There are simply no shortcuts to investment success. Just as important is the ability to learn from mistakes. That may seem like common-sense. But many rationalize their poor performance, deluding themselves that it was bad luck rather than considering the potential fault in the process. And just as important is time – knowing your investment well and staying focused on long term prospects when short term results don't turn out as planned.

Separating skill from luck continues to be difficult for the buyer of investment management services. Because buyer decisions are typically based on short term outcomes (recent performance), investment processes tend to be biased to short term goals. Unfortunately, that can result in either material underperformance or long term capital impairment.

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