Dimensional

November 29, 2011

What Does a Winning Streak Tell Us?

Weston Wellington, Down to the Wire
Vice President

Client Ready

Bill Miller is one of the most closely watched money managers in the industry, so it was big news when he announced his decision last week to step down as portfolio manager of Legg Mason Capital Management Value Trust (LMVTX) early next year. His departure also adds an intriguing chapter to the long-running debate regarding the value of active stock selection.

Miller's most frequently cited accomplishment is the fifteen-year period from 1991 through 2005, during which Value Trust outperformed the S&P 500 each calendar year, the only US equity fund manager to have ever done so. His success attracted a wide and enthusiastic following: Morningstar named him Portfolio Manager of the Decade in 1999, *Barron's* included him in its All-Century Investment Team that same year, and a *Fortune* profile in 2006 described him as "one of the greatest investors of our time." A former US Army intelligence officer and philosophy student, his formidable intellect covered a wide range of interests, and he believed that conventional investment analysis could be enhanced with insights drawn from literature, logic, biology, neurology, physics, and other fields not obviously related to finance. His expressed desire to "think about thinking" suggested an unusual ability to assess information differently from other market participants and arrive at a more profitable conclusion.

Miller's bold and concentrated investment style would never be confused with a "closet index" approach. Big bets on Fannie Mae, Dell, and America Online, for example, were rewarded with handsome gains (as much as fifty times original cost in the case of Fannie Mae). Unfortunately, similar bets in recent years revealed the dangers of a concentrated strategy as heavy losses in stocks such as Bear Stearns and Eastman Kodak penalized results. For the five-year period ending December 31, 2010, LMVTX finished last among 1,187 US large cap equity funds tracked by Morningstar. Considering the enormous variation in outcomes among these carefully researched ideas, Miller's overall investment record presents an interesting puzzle: How can we disentangle the contribution of good luck or bad luck, of skill or lack of skill?

Over the May 1982–October 2011 period, annualized return was 11.28% for the S&P 500 Index and 11.76% for the Russell 1000 Value Index. Value Trust slightly outperformed the S&P and underperformed the Russell index by over 0.40% per year. A three-factor regression analysis over the same period shows the fund underperformed its benchmark by 0.08% per month.

Do these results offer conclusive evidence of the failure of active management? Not necessarily. The fund's expenses are above average at over 1.75% and provide a stiff headwind for any stock picker to overcome. Gross of fees, the fund's performance over and above its benchmark goes from –0.08% to 0.07% per month. This swing from negative to positive raises an interesting point that Ken French speaks to at every Dimensional conference. There are almost certainly some mistakes in market prices and almost certainly some skillful managers who can exploit them. But who is likely to get the benefit of this knowledge—the investor with his capital or the clever money manager? If stock-picking talent is the scarce resource, economic theory suggests the lion's share of benefits will accrue to the provider of the scarce resource—just what we see in this instance.

To cloud the discussion even further, both of these results, positive and negative, flunk the test for statistical significance; in neither case can they be attributed to anything more than chance. So even with twenty-nine years of data, we cannot find conclusive evidence of manager skill—or lack thereof. This is the inconvenient truth that every investor must confront: The time required to distinguish luck from skill is usually measured in decades, and often far exceeds the span of an entire investment career.

Miller is well aware of the challenge of distinguishing luck from skill and has conspicuously declined to boast about his results, even when they were unusually fruitful. He has acknowledged that topping the S&P 500 each year for fifteen years was an accident of the calendar and that using other twelve-month periods produced a less headline-worthy result.

Commentators have said that Miller has "lost his touch" or that his investment style is no longer suitable in the current market environment. These arguments strike us as the last refuge for those who find the idea of market equilibrium so unpalatable that they search for any explanation of his change in fortune other than the most plausible one—prices are fair enough that even the smartest students of the market cannot consistently identify mispriced securities.

Where does this leave investors seeking the best strategy to grow their savings?

When asked by a *New York Times* reporter in 1999 to sum up his legacy, Miller replied, "As William James would say, we can't really draw any final conclusions about anything." Twelve years later, this observation seems more useful than ever. And investors would be wise to treat even the most impressive claims of financial success with a healthy degree of skepticism.

REFERENCES

Andy Serwer, "Will the Streak Be Unbroken," *Fortune*, November 27, 2006.

Edward Wyatt, "To Beat the Market, Hire a Philosopher," *New York Times*, January 10, 1999.

Tom Sullivan, "It's Miller Time," *Barron's*, October 12, 2009.

Diana B. Henriques, "Legg Mason Luminary Shifts Role," *New York Times*, November 18, 2011.

Standard & Poor's

Morningstar Inc.