

Even the Best Managers have Periods of Underperformance

A recent analysis done by Advisor-Intelligence and appearing in their monthly investment commentary took a look at mutual fund managers that outperform their peers over a ten year period. What they found was that even those managers of the best funds over a ten year stretch have periods of significant underperformance. The top managers will go through a stretch that will test the patience and discipline of their investors. The commentary points out three common traits of good managers.

1. Willingness to own unpopular names.
2. Make decisions based on long-term analysis.
3. Having the discipline to ignore short-term swings.

Perhaps investors that have money tied up in mutual funds should have these same traits. Too many investors look too closely at the short-term forgetting that having the discipline to think long-term leads to successful investing and better returns.

The analysis started with large caps. The information was obtained from Morningstar for the ten year period ending December 2005. There are 556 large cap funds that have at least a ten year track record. Of the 556 funds that had a ten year track record only 135 funds beat their benchmark during that time frame. The table, taken from the monthly commentary, breaks those funds into large-cap blend, value, and growth.

Group 1 is made up of all funds that beat the benchmark over a ten year period by 1% or more. The benchmarks used in the study are the S&P 500 for large blend, Russell 1000 Value for large value, and Russell 1000 Growth for large growth. As you can see, Group 1 shows 31 of the 201 large blend funds outperformed the benchmark. Fourteen of the 157 large value funds outperformed its benchmark and 90 of the 198 large growth funds outperformed over a ten year period. Looking further down in the table, you will see the percentage of outperforming funds that underperformed for any three year rolling period. Also, you can see 94% of the 31 outperforming large cap blend funds underperformed the benchmark by at least 2% per year over at least one three year rolling period. 71% of the 31 large cap blend funds underperformed by 5% per year for a three year period. 39% of

the 31 large blend funds underperformed the benchmark by 10% per period. Only 13% of the 31 outperforming large cap blend funds underperformed by 15% for any three year rolling period.

Further down the table is Group 2, which shows the same 556 large cap funds, but this group is the number of funds that outperformed the benchmark but had no portfolio manager turnover during the ten year period. Obviously, this group will be lower than Group 1. The results are also shown. Out of the 556 large cap funds only 59 outperformed its benchmark with the same manager over a ten year period of time.

The data in the table pictured below is shown as a bar chart on the following page.

A look at small cap funds also comes to a similar conclusion that large caps provided. The benchmarks that are used for the small cap funds are the Russell 2000 for small blend, Russell 2000 Value for small value, and Russell 2000 Growth for small growth.

A couple interesting things to note:

The percentages fall off dramatically for both large and small cap funds once the underperformance reaches 10% or more for a three year rolling period. In fact, no value fund whether large or small was able to overcome underperformance of 15% or more during a period and still beat the benchmark for ten years. No small value in particular could overcome a loss of 10% or more.

Every single outperforming value fund had at least one period where it underperformed by at least 2% or more compared to its benchmark, the Russell 1000 Growth or Russell 1000 Value.

The small cap universe has grown so much over the past few years, but the funds with a ten year track record are still much smaller than the large cap universe.

The universe they used took out all index funds and used only one share class per fund.

Conclusion

The best performing managers will underperform, but investors must have

Outperforming Managers' Experience with Underperformance

(for the 10 years ended December 31, 2005)

	Large-Cap Blend	Large-Cap Value	Large-Cap Growth	Small-Cap Blend	Small-Cap Value	Small-Cap Growth
Annualized index return	9.0%	10.7%	6.5%	9.0%	12.8%	4.4%
# of funds with a 10-year track record	201	157	198	57	33	99
Group 1 - all funds that beat the benchmark over a 10-year period by 1% or more annually						
# of funds	31	14	90	43	12	76
Annualized Underperformance	% of Group 1 that Underperformed over any Rolling 3-year Period					
>2%	94	100	93	98	100	88
>5%	71	64	68	72	50	66
>10%	39	21	24	49	0	22
>15%	13	0	7	16	0	11
Group 2 - funds with no manager turnover that beat the benchmark over a 10-year period by 1% or more annually						
# of funds	16	8	35	17	9	26
Annualized Underperformance	% of Group 2 that Underperformed over any Rolling 3-year Period					
>2%	88	100	91	100	100	85
>5%	63	63	80	82	67	65
>10%	31	25	29	47	0	27
>15%	13	0	11	18	0	15

Percentage of Large-Cap Funds that Lagged over 3 Years in the Midst of a 10-Year Stretch of Outperformance

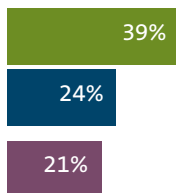
■ Large Blend ■ Large Growth ■ Large Value
 Percentage of funds that trailed for 3 years by at least 2% annualized



Percentage of funds that trailed for 3 years by at least 5% annualized



Percentage of funds that trailed for 3 years by at least 10% annualized



Percentage of funds that trailed for 3 years by at least 15% annualized

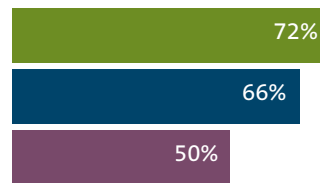


Percentage of Small-Cap Funds that Lagged over 3 Years in the Midst of a 10-Year Stretch of Outperformance

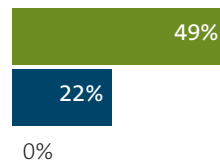
■ Small Blend ■ Small Growth ■ Small Value
 Percentage of funds that trailed for 3 years by at least 2% annualized



Percentage of funds that trailed for 3 years by at least 5% annualized



Percentage of funds that trailed for 3 years by at least 10% annualized



Percentage of funds that trailed for 3 years by at least 15% annualized



the discipline and long-term focus to ride out this underperformance. Allegheny's research department tries to select funds for the recommended list that have consistent superior track records over time, but most of those funds will go through tough periods where they will underperform the benchmark and peers. Most of the great managers do. When periods of underperformance are occurring, due diligence is very important to see why this is taking place. The monthly commentary points out that for larger portfolios it is a good idea to have two funds per category to protect against a manager's tough period. We would agree.

Some Allegheny Recommended Funds analysis over the ten year period:

American Funds Growth Fund of America

Fund	Russell 1000G	Out-perform	Under-perform
1995: 14.13%	13.14%	0.99%	
1996: 14.23%	20.12%		-5.89%
1997: 23.64%	30.14%		-6.50%
1998: 24.28%	30.62%		-6.34%
1999: 34.55%	34.07%	0.48%	
2000: 27.32%	12.74%	14.58%	
2001: 11.17%	-6.35%	17.49%	
2002: -9.74%	-23.64%	13.90%	
2003: -3.13%	-9.36%	6.23%	
2004: 5.08%	-0.18%	5.26%	
2005: 19.34%	13.23%	6.11%	

The fund had 3 three year rolling periods where it underperformed its benchmark by more than five percent and then went on to beat the benchmark by at least five percent from 2000 through 2005.

Davis New York Venture

Fund	Russell 1000V	Out-perform	Under-perform
1995: 18.93%	16.99%	1.94%	
1996: 19.70%	18.16%	1.54%	
1997: 27.93%	31.52%		-3.59%
1998: 18.28%	23.89%		-5.61%
1999: 17.61%	18.83%		-1.22%
2000: 13.79%	9.93%	3.86%	
2001: 15.19%	2.74%	12.45%	
2002: 4.39%	-5.14%	9.53%	
2003: 8.89%	1.22%	7.76%	
2004: 12.16%	8.57%	3.59%	
2005: 19.93%	17.49%	2.44%	

T. Rowe Price Small Cap Value

Fund	Russell 2000V	Out-perform	Under-perform
1995: 16.28%	15.29%	0.99%	
1996: 16.69%	14.54%	2.15%	
1997: 27.25%	26.23%	1.02%	
1998: 11.74%	14.38%		-2.64%
1999: 4.25%	6.69%		-2.44%
2000: 1.99%	4.22%		-2.23%
2001: 13.91%	11.32%	2.59%	
2002: 12.79%	7.45%	5.34%	
2003: 17.79%	13.83%	3.96%	
2004: 18.99%	16.5%	2.49%	
2005: 23.08%	23.18%		-0.10%

Columbia Acorn

Fund	Russell 2000G	Out-perform	Under-perform
1995: 13.67%	13.17%	0.50%	
1996: 10.79%	12.47%		-1.68%
1997: 22.46%	18.09%	4.37%	
1998: 17.24%	8.35%	8.89%	
1999: 20.60%	17.83%	2.77%	
2000: 15.59%	3.96%	11.63%	
2001: 15.52%	0.25%	15.27%	
2002: -0.05%	-21.11%	21.06%	
2003: 9.63%	-2.03%	11.66%	
2004: 14.76%	5.79%	8.97%	
2005: 25.51%	20.93%	4.58%	

Columbia Acorn is one of only 9 small cap growth funds that beat the Russell 1000 Value for a ten year period and never trailed the benchmark by more than 2% during any three year rolling period. ■