ALBION FINANCIAL GROUP

Wealth Advisors, Investment Managers

Understanding the Nuances in Investment Performance

Measuring investment performance is an art, not a science. For many this notion can prompt an uncomfortable response as it repudiates what should be entirely impartial statistical information. The reality however is that there are many subjective conditions that dictate the numerical output of such analyses. Therefore, it is important to have a thorough conversation around various performance data in an effort to understand both its meaning and significance.

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The first subjective gate that presented investment performance must pass through is time frame, or the specific period being measured. Take for example the following simple exercise in examining a hypothetical portfolio return versus a stated benchmark (more on benchmarks in a moment). Let's say an investor owns a portfolio of stocks that exactly mirrors the Russell 2000 basket ("Russell"). At the time this paper was written on a year-to-date (YTD) basis this portfolio had a negative price return of approximately -2.02% through 11/23/2015. As a point of orientation the Dow Jones Industrial Average ("Dow") is down -0.17% over this same period, resulting in this portfolio underperforming the Dow by roughly -1.85% YTD. What actionable implications can one draw from this data? Should our investor make any changes to our portfolio as a result of this information?

Now let us expand that time horizon by only one short month. Our hypothetical Russell-like portfolio return is now +0.17%, while the Dow is off -0.02%. The relative performance of this portfolio has quickly become +0.19% when studied over this second period of time! Through this lens, is this portfolio doing what is should be doing? Would it have been wise to trade out of this Russell replica portfolio and into the Dow based on our early impressions of period 1?

We are all human beings with instinctive impulses; it's just the way we're wired. And in this situation it wouldn't be unusual for an investor to desire a switch based on information

gleaned from the first time period. However, when adding a supplementary data point to the mix – i.e., time period 2 – this instant reaction in labeling the portfolio as an "underperformer" may have been a rush to judgement and warrants further examination.

In an effort to counter this urge an analysis of these two strategies over a longer observable period is a good place to start. Put differently, which portfolio has delivered ample and *steady* returns over time? In our hypothetical scenario we see the Russell basket returning +73.5%, +163.5%, and +280.8% over 10-, 15-, and 20-year periods, respectively. An investment in the Dow, meanwhile, would have delivered +64.6%, +71.1%, and +251.2%, respectively, over these same periods. How would we imagine our hypothetical investor to behave had we began our analysis with this perspective? Or perhaps even more frightening, what would have been the financial impact to one's portfolio if they had made the decision back in, say, the year 2001 to switch from the Russell strategy to the Dow after a couple of bad months, or even bad years?

To be sure, overactive short-termism and myopic performance chasing can be damaging to an investor's financial goals. On the other hand, long-term ownership of good businesses (stocks) and a focus on performance over extended horizons is a solid beacon in an environment fixed to 24-hour news cycles and a nearsighted measuring of returns. This rhythm affords the astute manager the latitude to administer the indispensable elements of patience and discipline.

"Long-term investors are the financial market equivalent to marathon runners."

Indeed, long-term investors are the financial market equivalent to marathon runners. Yet in today's fast moving connected world of always-on digital information, social media, intense scrutiny on quarterly earnings results, and enormous pressure to deliver short-term results, we are often clocked every 100-meters as though we are running sprints. This does not make sense and fuels a fundamental mismatch that can lead to flawed measurements, or worse yet strategic mistakes towards an investor meeting their long-term financial goals. Quite simply, it's the wrong tool for the wrong job – like asking for a hammer to screw in a bolt.

A more suitable and effective analysis is to observe the two portfolios over a much longer period of time in order to smooth out shorter-run dispersions and more clearly assess the consistent pace and performance of an investment portfolio. Patience and discipline are paramount to long-run investment

success, much like the way we would evaluate a marathon runner.

The second subjective gate that performance must pass through is relative benchmarking. In our previous example, why did we select the Dow as our relative measure? Why not the S&P 500? Wilshire 5000? German DAX, or the Shenzhen in China? MSCI World index, anybody? How about stocks in the U.S. health care sector, or in energy? Did these perform better or worse than our portfolio? How would the presentation of this material have affected our evaluation? And more important, what can we do with all of this information? Does it make us better or worse decision makers? We belabor the point, but what's key to appreciate is that there are almost an infinite number of options one can choose when buying stocks (or index funds), and thus scenarios for comparing actual returns against theoretical opportunities are equally as vast.

"Our ultimate goal as holistic wealth managers is to help our client's reach theirs."

We certainly recognize that it is easy to get caught up in the media hype obsessing over the one or two most widely-cited indices. Nevertheless, we believe that this focus is an arbitrary exercise and tells us nothing about the merits of an individual investor's portfolio needs, strategy, and financial goals.

Albion Equity Performance

With this understanding we encourage our clients to apply the same analytical framework when assessing Albion's investment management acumen. And we are pleased to report that our marks here are emphatically positive. Our ultimate goal as holistic wealth managers is to help our client's reach theirs. At present we currently manage assets for over 400 families, across 2,000+ accounts, each with unique situations and needs. This custom and client-centered approach does not lend itself to a *one-size-fits-all* performance figure. Rather, we firmly believe that the purest gauge in measuring our value and determining our performance can be seen by whether or not our clients are happy and retain our services. Indeed, it is this behavior that embodies the most conclusive vote of confidence and judgement of our ability we can think of.

Albion has been in business for 33 years, and over this time our client turnover has been very low; a fact that we are extremely proud of. In addition to the custom nature of our services, industry rules as they apply to fiduciary managers – the highest standard in the investment industry – makes it quite difficult for us to formally engage in traditional returns reporting conventions.

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To help you understand why, a brief description of the difference between fiduciary and suitability standards is necessary. It sounds complicated, but essentially the difference between the two standards refers to the guidelines that spell out the obligations financial services professionals have to their clients.

The suitability standard gives advisers the most wiggle room: It simply requires that investment vehicles fit clients' investing intents, time horizon, and experience. As a result the suitability standard invites conflicts of interest pertaining to compensation, which can greatly influence what financial products are pushed onto clients. Conversely, the fiduciary standard requires advisers to put their clients' best interest ahead of their own. For instance, faced with two identical products but with different fees, an adviser under the fiduciary standard would be bound to recommend the one with the least cost to the client, even if it meant fewer dollars in the company's coffers – and thus his or her own pocket.

We think it is clear which standard is superior, and we take very serious our adherence to these principles. Yet, this also handcuffs us when it comes to presenting official performance data to prospective clients. Meanwhile, those firms that follow the less rigorous and conflict-riddled suitability standard are permitted wide latitude in providing this data. While we argue that this is frustratingly irrational, we also recognize that we do not make the rules and therefore must follow industry regulations as they are, not as we wish them to be.

With that said, here's what we *can* share with you.

While we are active managers tirelessly monitoring markets in real-time keenly attune to present information, at our core we are long-term oriented (i.e.,

the "marathon runner"). Consequently we are proud of the excellent results we have generated for our clients. However there are times when even the best managers will have soft spots in their returns. An example of this for us would be the year 2012 where we left some upside on the table in our equity portfolios and underperformed the broad averages in a conscious decision to protect our clients' hard-earned nest eggs.

In 2012 the world got very scary, very quickly. The U.S. economy had turned sour in the late-spring (particularly employment data) and Europe was at the height of a potential Greek debt default and ensuing contagion. Not only was Greece looking into the abyss, but the entire European periphery (e.g., Italy, Spain, and Portugal) was fragile enough that any policy misstep would have likely held grave consequences. There were riots in the streets, sweeping anti-euro sentiment, and against this backdrop we made an active decision as active managers to raise cash to protect our client's assets. Our calculus at the time was while a decent chance did exist that this strategy would dent short-run performance if the market moved higher; the sheer magnitude of the market downside if things collapsed necessitated a defensive posture. Indeed, if the euro had fractured during this time the ripple of global banking contagion, general fear, and economic retrenchment would have been disastrous to equity markets. The probability of such a scenario in our view was high enough to warrant more than a healthy dose of caution. As holistic wealth managers with a *fiduciary* responsibility we had to act in the best interest of our clients.

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Despite these large macro risks the S&P 500 finished the year up +16%, while the Dow returned +10.2%. For us, our abnormally high cash level created a drag on equity returns causing us to end the year only slightly positive. And while this does skew the various short-run performance data sets, we own this decision and would do it again if the environment called for it.

We feel very strongly and take very serious our duty to protect client assets. In our view this form of cognitive, yet assertive risk management cannot be captured by traditional attribution and returns reporting methods. Please do not mistake our explanation as an excuse. Quite the contrary, we believe that it is

precisely these types of active decisions and attention to downside protection that helps drive investment returns over the long-run. As such we felt it both appropriate and necessary to provide this context.

As the world chewed through some of the more terrifying moments of that year – e.g., German Supreme Court ruling declaring the euro bailout mechanisms legal; a restructuring of Greek debt from the private sector to the IMF / ECB / EC who could better absorb potential losses; euro members assembling the sound regulatory framework necessary to backstop the financial system; etc. – we scaled back into quality stocks utilizing our time tested rigorous fundamental approach.

"Without question, what matters most is creating the right investment portfolio to achieve your financial goals."

Hindsight is always 20/20. Was this a sound decision to go to cash given the severe risks we were seeing, or should we have put our blinders on and gritted our teeth through it? In discussing this with our clients at the time, an analogy we found helpful in imparting our thinking as we made this decision is as follows.

Suppose you were offered a free flight to anywhere in the world. Rome; the pyramids of Egypt; Japan; the South Pacific; any place you've most wanted to visit is now at your finger-tips at no cost to you. Sounds great, right? The catch is there's a 20% chance that the plane you're riding on will be involved in a horrific crash. Would you accept the offer? Put differently, there's an 80% chance you make it there just fine. And yet does that make you feel any better about accepting this deal? Probably not. Why? Because the risk – albeit far less likely relative to the odds of a gain – holds such grave consequences that it is simply not wise to chance it. This is precisely how we viewed the stock market and the potential negative impact on our clients' portfolios during the global chaos in 2012.

Summary

Wealth management has an almost unlimited number of variables and unique situations. Unfortunately, the desire by the media and Wall Street marketing to distill down this complexity into imperfect short-term investment returns data, particularly in cohabitation with a randomly selected arbitrary benchmark, has created a distraction that few can afford to have.

Chasing short-run manager performance can be every bit as damaging to long-run portfolio returns

as hopping in and out of hot and cold stocks without any attention paid to the fundamentals of the underlying companies. While we surely understand the virtue of considering market returns as a component of the overall wealth management picture there is far too great a focus placed on it, both versus stated benchmark(s) and over increasingly shorter time horizons.

This works in both directions. When a manager is crushing it with great returns above their specified benchmark over short periods of time, publicizing this as sustainable and reason to invest is every bit as imprudent as eschewing a smart, high quality manager with a laudable and principled investment philosophy demonstrating sound long-run risk-adjusted returns. *Sometimes* we fall into the former category, but we will *always* fall into the latter.

Without question, what matters most is creating the right investment portfolio to achieve *your* financial goals. This is challenging, and candidly it always has been and likely always will be. But, it is a worthy and important goal – one that all of us on the Albion Team are proud to devote our professional careers to helping clients attain.

Author Biography

As Chief Investment Officer, Jason Ware steers Albion Financial Group's Investment Management Team through complex and ever-changing markets. In his role as the firm's CIO Jason helps to design, oversee, and execute Albion's rigorous top-down investment approach within the context of client's investment policies. His work provides the foundation for client portfolio construction, and forms the basis for the firm's opinions and outlook on the global economy & financial markets. Jason earned his MBA from Westminster.

Jason's knack for identifying market trends and thoughtful views on the world economy has distinguished him as a resource for the financial press - frequently quoted in articles from Reuters, The Wall Street Journal, Investment News, and American Banker. Jason has also been a guest on CNBC television. Local press includes articles by Deseret News and live interviews on KSL News Radio. Jason also writes Albion's blog on the economy and markets.