



“In hindsight, poor choices with happy endings are described as brilliant choices, and unhappy endings of well-considered choices are attributed to horrendous choices.”

— **Meir Statman, Glenn Klimek Professor of Finance at the Leavey School of Business, Santa Clara University, *What Investors Really Want***

Alpha Bits or Lucky Charms?

By: Mary Brunson & Jay D. Franklin | December 21, 2011

The long-standing debate regarding active vs. passive investing really boils down to one simple question: Is the excess (above benchmark) return earned by a manager due to luck or skill? With some 7,000 actively managed funds available, this question can be ferreted out by digging into the returns and variability of returns records of managers who have demonstrated persistence in delivering the elusive alpha.

The most noteworthy of such managers is Bill Miller who holds the record for the longest-running streak of outperforming the S&P 500 Index. During the 15-year period from 1991 through 2005, Miller's stock picks led the Legg Mason Value Trust Fund (LMVTX) to consistently defeat the widely used benchmark index.

Miller's feat brought him great notoriety. In 1999, he was named Morningstar's "Fund Manager of the Decade," and he was also included as part of Barron's "All-Century Investment Team." These accolades caused his fund to swell from \$750 million in 1990 to more than \$20 billion by 2006 when Forbes declared Miller to be "one of the greatest investors of our time."

Miller's hot streak turned cold, however, when big bets in the financial sector during 2008 sent LMVTX into a downward spiral. By November 2011, the fund's value had contracted to a mere \$2.8 billion and Miller announced he would retire from the fund in the spring of 2012, thus removing any opportunity to reclaim his previous record.

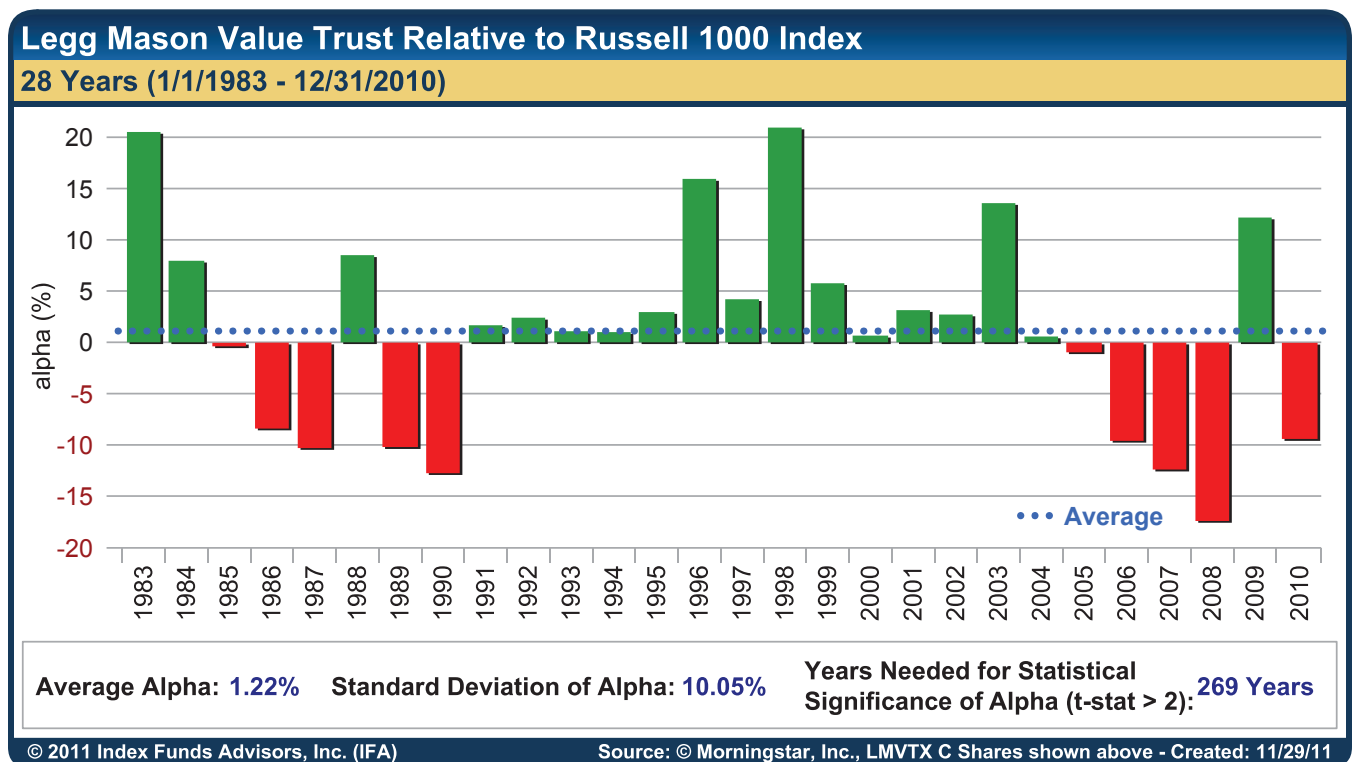
Was Miller's winning streak a result of skill in delivering alpha or mere luck? Alas, we will never know. Much more time is required to establish a high degree of confidence that Miller possessed stock-picking skill. And, to be fair, even if he had stayed on to redeem a presumption of prowess, it would take an additional 241 years of data to make this determination. While Miller is the only manager to have beaten the S&P 500 Index for 15 years, he remains mortal.

To see if you have enough years of returns to have reason to believe the manager has genuine skill, as opposed to fleeting luck, you simply need to enter two numbers into a calculator. They are:

- 1) The average difference in returns between the fund and the benchmark, known as the alpha
- 2) The standard deviation of the alpha

The calculator (see <http://www.ifa.com/12steps/step3/step3page3.asp#t-statCal>) will then produce the number of years needed.

In order to establish this number for Miller, IFA compared his returns to the Russell 1000 Index (Morningstar's designated benchmark) on a calendar year basis from fund inception through 2010. When the alpha and standard deviation of the alpha are entered, the calculator says we need 269 years of returns similar to Miller's before an investor can anoint Mr. Miller as skilled.



The problem for manager pickers is that the process largely focuses on the search for alpha bits, without considering the possibility that they might get lucky charms. Manager pickers should ask: “Is there a higher expected return with active managers, or am I just increasing the risk that my portfolio will go snap, crackle, pop?”

It is IFA’s privilege to share this information with you. Each of our investment professionals welcomes the opportunity to assist you in your quest for risk-appropriate, low-cost returns. To learn more, please call 888-643-3133 or visit www.ifa.com.

This information has been furnished to you by Index Funds Advisors, Inc., a fee-only Independent Financial Advisor registered with the United States Securities and Exchange Commission. Please see www.ifabt.com for complete sources, updates and disclosures.

DISCLAIMER: THERE ARE NO WARRANTIES, EXPRESSED OR IMPLIED, AS TO ACCURACY OR COMPLETENESS OF ANY INFORMATION INCLUDED IN THIS DOCUMENT. Use of any information obtained from such addresses is voluntary, and reliance on it should only be undertaken after an independent review of its accuracy, completeness, efficacy, and timeliness.

WARNING: Past performance does not guarantee future results. Investment returns and principal value will fluctuate, so that investors' shares, when sold, may be worth more or less than their original cost. Investing in any mutual fund, index or actively managed, does not guarantee that an investor will make money, avoid losing capital, or indicate that the investment is risk-free. Actively managed funds sometimes outperform index funds. You just don't know in advance which actively managed fund will outperform the appropriate index. Just because a mutual fund is an index mutual fund, it does not guarantee a performance superior to an actively managed mutual fund. There are no absolute guarantees in investing. When reviewing any backtested performance information on this internet site, please read the Disclosure for Backtested Performance Information at www.ifabt.com.



Index Funds Advisors
matching people with portfolios

Index Funds Advisors, Inc.
19200 Von Karman Ave., Suite 150
Irvine, CA 92612

Call Toll Free: 888-643-3133
Local Phone: 949-502-0050
Fax: 949-502-0048