WHAT CAN THE LITTLE GUY LEARN FROM INSTITUTIONAL INVESTORS?

BY

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When you look at the stock market and the behavior of all different types of investors over time, it's easy to see different investing patterns emerge. A difference we have often seen is between the retail investor (usually individuals like you and me investing for themselves and their families) and the institutional investor (corporations, pension funds and the wealthiest individuals and families).

By and large, our experience at Compass has shown that:

Institutional Investors	**Individual Investors**
Attempt to control risk	Chase return
Trade on scientific analysis	Trade on emotion
Invest long-term	Buy/sell short-term
Use professional money managers	Make investment decisions themselves
Minimize expenses	Don't consider expenses
Use a **process**	Act haphazardly

As a result, institutional investors usually do much better than the retail investor. For example, a December 1999 Dalbar study showed that over the 15-year period from 1984 to 1998, the S&P 500 Index gained a total of 1082.83% for an annualized return of 17.90% - but the average equity fund investor only gained a total of 185.73% for an annualized return of 7.25%.

So it is reasonable to ask, "What do institutional investors do, and how can I apply this process to my own investing?"

If you look at how many institutions invest, you can see four basic principles:

- Asset allocation
- Portfolio structure
- Multiple specialist managers
- Continuous portfolio management

Although all four principles can sound complex and confusing, like most technical subjects they have very basic foundations:

ASSET ALLOCATION--THE MOST IMPORTANT STEP IN THE INVESTMENT MANAGEMENT PROCESS

Many investors believe trying to "time" the market and picking the next "hot" stock are the keys to success in reaching their investment goals. The financial media, and some investment companies, perpetuate this myth. For example, financial magazines and rating services frequently publish ever-changing lists of top-performing mutual funds and money managers. Many investors turn to these publications for guidance; unfortunately, these rankings <u>cannot</u> predict future success.

In fact, research suggests that flipping a coin will offer about as much insight on money manager skill as relying solely on past performance. A study by SEI Investments Management Corporation of pension fund investment performance during the late 1980s through late 1990s demonstrated that *over half of the money managers who ranked among the top 25% from 1988 to 1992 went on to rank in the bottom 50% from 1993 to 1997.*

In other words, a top-performing money manager today has a 50/50 chance of being a bottom-performer in the future.

So how do you reach investment success if you can't depend on the past?

An authoritative study of pension fund performance found that the success or failure of an investment strategy depended not on which securities or mutual funds were bought or sold, or when. The key was <u>how the assets were divided among the various asset classes (stocks, bonds, cash equivalents)</u>.

How your assets are allocated is directly related to your investment objectives--your time horizon to invest, your ability to handle risk, and the overall goal you want to reach.

So the most important steps in the investment process are those in which an investor's objectives are carefully *defined,* then *implemented* with an appropriate asset allocation strategy.

DIVERSIFY YOUR PORTFOLIO BOTH ACROSS AND WITHIN ASSET CLASSES

The stock and bond markets are composed of numerous styles and sectors. For example, there are four different major styles of US securities--large capitalization and small capitalization stocks as well as growth and value stocks. To increase your chance at success, your portfolio should be diversified across and within these asset classes as well. In other words, you shouldn't just buy "stocks" but also make sure you have the right mix of large cap, small cap, growth and value.

Institutional investors stress the importance of identifying the <u>style specialty</u> of a money manager because how stocks perform within each style tends to be similar. In addition, a subsequent study by SEI Investments Management Corporation shows that money managers who specialize in a style of stock or bond tend to outperform "generalist" money managers who buy stocks or bonds over several different categories

This vital component in the asset management process is often overlooked by advisors who do not have access to state-of-the-art research and monitoring capabilities. This can cause you to "bet" too much of your portfolio in certain styles or segments of the market. So the institutional investor insists on carefully designed strategies that utilize the domestic equity market, the international equity market, and the fixed income market as well as different styles of stocks and bonds.

SPECIALIST MONEY MANAGERS CAN IMPROVE YOUR RESULTS

Specialist money managers who concentrate on one investment discipline (such as large cap growth managers) can focus on and become experts within a smaller area. This focus may potentially mean greater consistency and predictability of results. In contrast, many money managers roam about the market in search of "good" opportunities, but they end up missing most. All this activity contributes to unneeded volatility in a portfolio.

The use of multiple specialist managers fits in with the institutional investor's requirement to diversify. By building your portfolio with experts in the various sectors and styles, you can increase the chance for full coverage of all the market sectors. And institutional money managers, who traditionally have served large companies and the ultra-affluent, have been less susceptible (within their designated investment mandates) to the pressure to become generalists and follow the mass market. So an institutional specialist money manager would make a better candidate.

But there are some 13,000 institutional money managers in the world today. How do you find the super managers?

The manager selection process includes both exhaustive quantitative analyses and an examination of the philosophy, process, and people that contribute to the firm's performance. You should look at:

Performance
How does the manager do against his peers? Across market cycles? Is he or she consistently within one particular style?

Philosophy
Is there a clearly defined investment philosophy and style, such as growth or value, or large or small companies, that has been consistently applied over a number of market cycles?

Process
Is there a commitment to researching new investment opportunities? A discipline in making buy and sell decisions? This is particularly prevalent with institutional managers.

People
Look for stable, well-managed organizations who attract and retain outstanding investment manager talent within a team approach.

CONTINUOUS PORTFOLIO MANAGEMENT IS ESSENTIAL

Portfolio management must be a continuous process. Once your needs are defined, a plan developed, and strategy implemented, ongoing analysis and "fine-tuning" takes place.

The institutional investment process does this two ways: by **rebalancing** the asset mix back to its target and by continually **monitoring** and "rehiring" the specialist managers in the portfolio.

Market movements may cause your allocations to drift away from original positions. For example, if you originally set up 60% of your assets in stocks, and these stocks increase in value, you could end up with 70% or more of your portfolio in stocks over time. This can create unintended and unnecessary risks. **Rebalancing** your portfolio back to its original structure (in this case, 60% in stocks) keeps your asset allocation on the right course.

Even after a manager is chosen, you should continuously and rigorously **monitor** his/her philosophy, process, people and performance. And of course you need to check portfolio holdings and trades on a daily basis to ensure "purity" of the investment portfolio.

How can an individual invest like an institution?

Up until recently, the answer was, "You can't." The minimums required to access these institutional, specialist money managers may range as high as $100 million per account. But now a few Investment Advisors such as Compass can access these programs through a partnership with SEI Investments, a global asset management firm with a tradition of institutional manager analysis and monitoring.

Your Trusted Financial Advisor at Compass understands your individual goals well enough to develop and monitor a tailored asset management program. Once established, institutional investment solutions offer the diversity and clarity of purpose to fit virtually any type of strategy. And you always have the flexibility to adjust your strategy as your personal situation changes.

The result is a disciplined, fully coordinated program, not just a random collection of uncorrelated "hot" investments.

In other words, the institutional investment process.

For the record and at the risk of overstating the obvious- the institutional investment process is what we use with our clients.