
Reflections on Fund Management: Five Lessons from 25 Years

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Lesson One:
Leadership is Not Permanent

Biggest U.S. Fund Firms 1986

1. Merrill Lynch

2. Fidelity

3. Federated

4. Dreyfus

5. Franklin

6. Dean Witter

7. Kemper

8. Putnam

9. Pru-Bache

10. EF Hutton

11. Shearson

12. IDS

Biggest U.S. Fund Firms 2011

1. Vanguard

2. Fidelity

3. American Funds

4. BlackRock/iShares

5. PIMCO

6. JP Morgan

7. Franklin Templeton

8. Federated

9. T. Rowe Price

10. State Street Global Advisors

11. Dreyfus

12. Columbia

Long Gone

- ▶ Merrill Lynch
- ▶ Dean Witter
- ▶ Kemper
- ▶ Putnam
- ▶ Pru-Bache
- ▶ EF Hutton
- ▶ Shearson
- ▶ IDS

New Entrants

- ▶ Vanguard
- ▶ American Funds
- ▶ BlackRock/iShares
- ▶ PIMCO
- ▶ JP Morgan
- ▶ T. Rowe Price
- ▶ State Street Global Advisors
- ▶ Columbia

Reinvented or Surviving on Money Market Assets

- ▶ Fidelity
- ▶ Franklin Templeton
- ▶ Federated
- ▶ Dreyfus

Lesson Two:
Predictions Often Miss the Mark

1986 Predictions

- ▶ Banks will join brokerages and dominate industry because they control distribution
- ▶ No-load funds will win from disintermediation theme
- ▶ Passive funds will trump active, as academic evidence supports indexing

2011 Reality

- ▶ Both banks and brokerages blew it. Owning distribution didn't lead to success
- ▶ No-load shops like Vanguard and T. Rowe Price did win, but so did load shops like Franklin, American Funds, and JP Morgan. Many like Fidelity simply offered both load and no-load funds
- ▶ Passive shops like Vanguard, I-Shares, and State Street Global Advisors did win, but so did active shops like Fidelity, PIMCO, American Funds

Predictions Generally Misguided

- ▶ The way the debate was framed was often wrong or beside the point
- ▶ Smartest people in the industry focused on many of the wrong things
- ▶ Lots of wasted effort and ink
- ▶ We should remember past debates and be humble in future predictions

Lesson Three: Change is Not Random

Shared Traits of Winners and Losers

Losers

Closed architecture

Higher cost

Hot concepts

Short-term sales focus

“Funds are sold”

Winners

Open architecture

Lower cost

Investment merit

Long-term investor focus

“Funds are bought”

Salesmanship vs. Stewardship

Salesmanship

Merrill Lynch

Dean Witter

Pru-Bache

EF Hutton

Shearson

Stewardship

Vanguard

American Funds

JP Morgan

T. Rowe Price

PIMCO

Lesson Four:
Investor Experience is Paramount

Asset Managers Often Focus on the Wrong Things

What We Focus on

- ▶ Near-term investment performance
- ▶ Fund category ranking
- ▶ Finding hot fund, asset class

What Matters

- ▶ Long-term investor experience
- ▶ Retaining clients
- ▶ Curbing investor instincts
- ▶ Clients achieving goals

The Real Test is Whether Investors Succeed

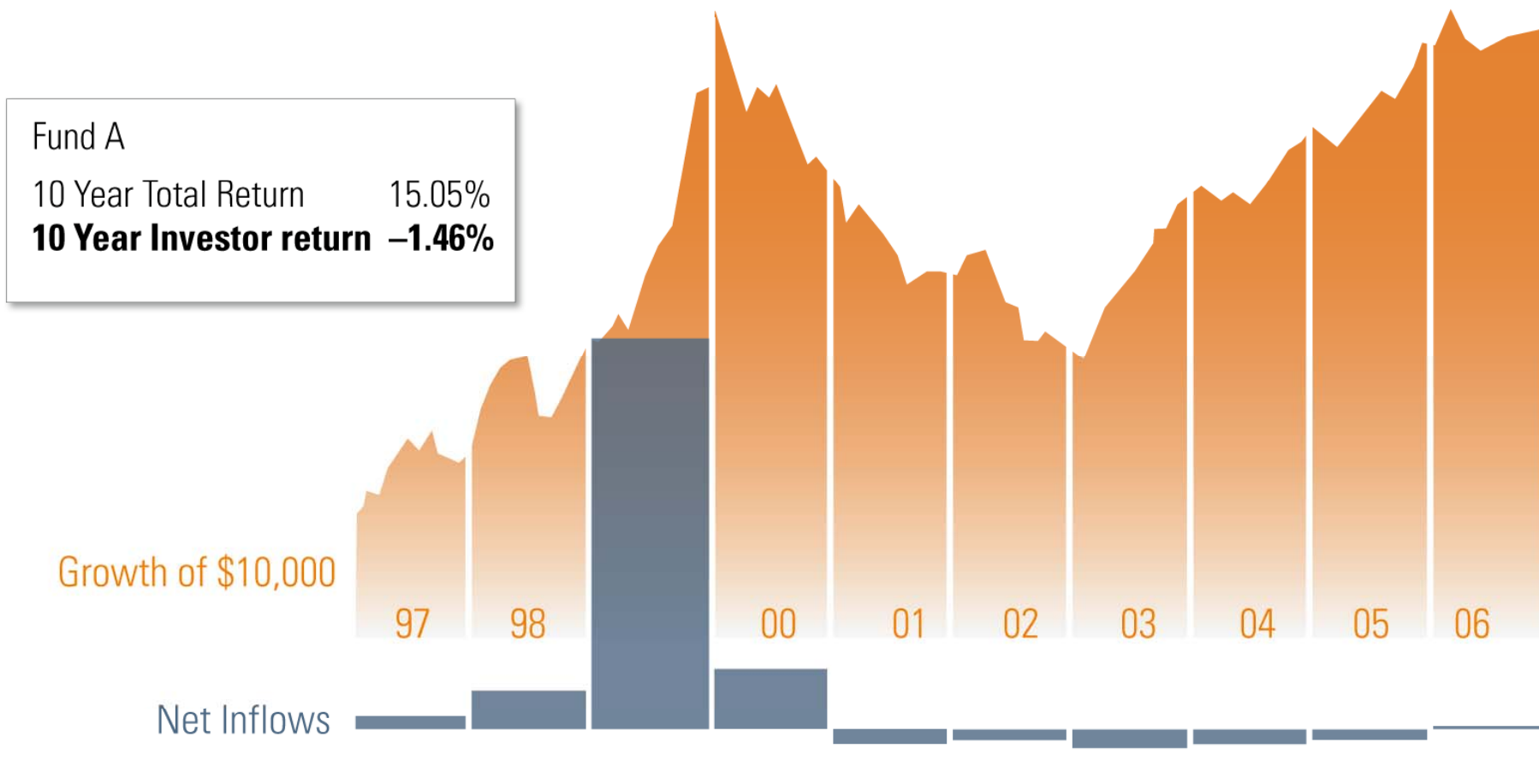
Total Return

- ▶ Time-weighted calculation
- ▶ Assumes investor buys and holds for entire period with no additional investments

Investor Return

- ▶ Money-weighted calculation
- ▶ Accounts for aggregate monthly purchases and sales by all of a fund's investors

Investors Often Miss Benefits of Fund Ownership



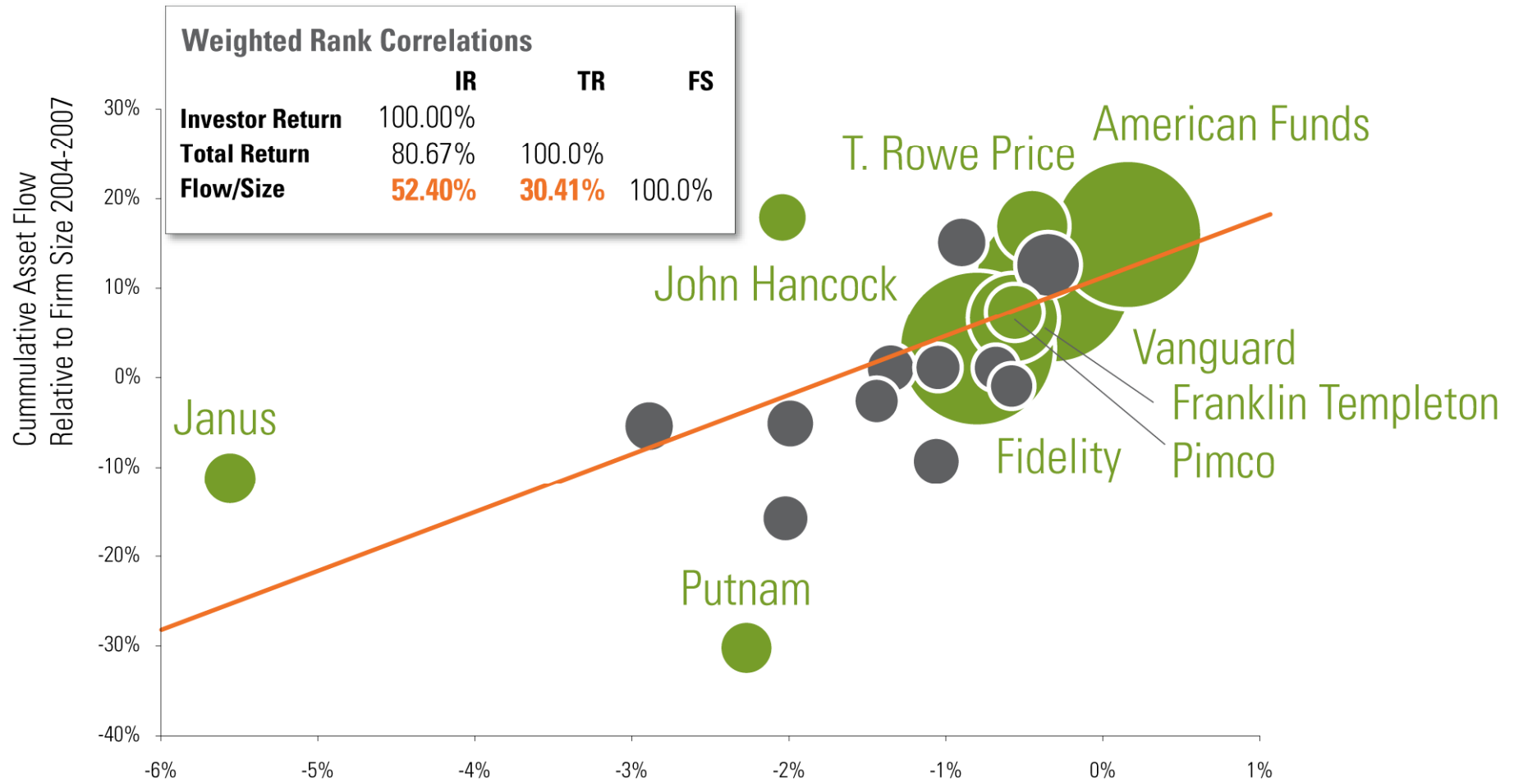
| | | | | | | | | | | |
|--------------------|------|------|-------|-------|-------|-------|------|------|------|------|
| Annual Return (%) | 12.7 | 34.9 | 120.1 | -17.1 | -27.8 | -17.7 | 43.8 | 20.9 | 24.4 | 8.8 |
| Net Assets (\$mil) | 5.3 | 9.9 | 72.4 | 118.9 | 69.1 | 45.6 | 52.2 | 51.9 | 57.1 | 63.2 |

Behavior Gap Exists Among All Types of Funds

| Fund Group by Asset Class | Investor Return | Total Return | IR-TR Gap |
|---------------------------|-----------------|--------------|-----------|
| U.S. Diversified Funds | 2.32 | 3.30 | -0.98 |
| U.S. Sector Funds | 3.89 | 6.08 | -2.19 |
| Balanced Funds | 3.96 | 5.13 | -1.17 |
| Intl. Diversified Funds | 4.92 | 5.98 | -1.06 |
| Intl. Regional Funds | 6.37 | 8.77 | -2.40 |
| Taxable Bond Funds | 4.46 | 6.27 | -1.81 |
| Municipal Bond Funds | 2.04 | 4.02 | -1.98 |
| Alternative | 9.94 | 13.07 | -3.13 |
| All Funds | 3.38 | 4.71 | -1.33 |

Asset weighted returns, 10 years ending 12/31/2010

It Pays to Mind the Gap



Investor Return—Total Return Gap
10 YR Returns thru Dec. 31, 2007

Lesson Five:

We are All in the Behavior Modification Business

Fund Promotion Needs to Change

- ▶ January 2000 peak: Tech funds dominate fund ads
- ▶ January 2003 trough: Government bond funds widely advertised
- ▶ Summer 2007 peak: Leveraged ETFs prominent among fund ads
- ▶ February 2009 trough: Absolute return funds highly advertised
- ▶ The industry has long history of encouraging risk taking at peaks and caution at troughs

Manager Interests Should Be Aligned with Shareholders'

| Ownership Level | % Rank Cat 5yrs | # of Funds |
|---------------------------------|-----------------|------------|
| More than \$1,000,000 | 39 | 391 |
| Between \$500,001 and \$999,999 | 42 | 194 |
| Between \$100,001 AND \$500,000 | 45 | 656 |
| Between \$50,001 AND \$100,000 | 48 | 273 |
| Between \$10,001 AND \$50,000 | 52 | 367 |
| Between \$1 AND \$10,000 | 53 | 144 |
| \$0 | 53 | 1,860 |

Ownership data is based on the most recent SAI as of 2/28/2010

Manager Investment Correlates with Stars

| Star Rating | Tenure (Years) | Manager Investment |
|-------------|-------------------|-----------------------|
| 5 | 6.2 | \$300,061 |
| 4 | 6.3 | \$250,890 |
| 3 | 5.4 | \$161,602 |
| 2 | 4.6 | \$124,810 |
| 1 | 3.8 | \$110,991 |

Morningstar Principia, 01/31/10

Amplify or Moderate?

- ▶ Fundamental moral choice: Do you amplify or moderate fear/greed cycle?
- ▶ In the long run, amplifiers lose
- ▶ In the short run, amplifiers can make lots of money and inspire copy cats
- ▶ Advisors must ask with whom are they are willing to do business?
- ▶ In time, if the investor doesn't win, we all lose

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