Institutional Investor

Winning the active management game

In Unconventional Success: A Fundamental Approach to Personal Investment *(Free Press, August 2005), investing legend David Swensen, chief investment officer of Yale University, argues that the for-profit mutual fund industry has been a "colossal failure" for shareholders. In the excerpt printed here, from Chapter 10, Swensen offers advice to help individual investors triumph over very daunting odds.*

As a general rule, the corporate bottom line wins the battle between a mutual fund's obligation to serve as a fiduciary to investors and a mutual fund's quest to produce profits for its owners. Every improvement in net income for a mutual-fund organization diminishes the account of the mutual-fund investor. In the case of excessive management fees, indefensible distribution fees, high portfolio turnover and bloated portfolio size, the causes of disappointing results stare investors directly in the face. In the case of product placement payments to brokerage firms, stale price trading activity and soft-dollar kickbacks, the damage to investor portfolios remains largely hidden from view. Mutual-fund shareholders operate in a challenging environment.

Some rays of hope shine through the dark clouds that obscure investor aspirations. The vast population of the fund industry contains a small subset of truly talented investors who deserve the trust associated with managing assets of others. Within that small subset, a handful of mutual-fund managers transcend the pure pursuit of profit, placing the selfless service of investor needs above the selfish search for personal gain. In those rare instances in which mutual-fund managers own a significant stake in the funds that they manage, the manager transmutes from agent to principal, dramatically increasing the odds of serving investor interests. Mutual-fund owners increase the chances of success by choosing to invest with management companies that place investor interests front and center.

For those intrepid investors hoping to identify a market-beating mutual fund, assessing the manager's personal characteristics tops the list of investment criteria. Active management success depends on investing with individuals who exhibit the integrity to pursue the often uncomfortable policies that lead to generation of superior investment returns. For example, structuring concentrated portfolios and owning out-of-favor securities generally prove both helpful to investment success and hurtful to personal reputation. Mutual-fund investors face the difficult problem of evaluating the character of fund managers, a task that involves tough, qualitative judgments regarding information that proves nearly impossible for the individual investor to gather.

Not only do mutual-fund investors seeking to beat the market need to identify courageous portfolio managers willing to go against the grain of conventional wisdom, but prospective investors must find fund management organizations that place

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investor interests ahead of corporate profits. Unfortunately, in the asset-gathering mutual-fund world, managers who exhibit prudence in capping or closing funds represent the rare exception to the profit-maximizing rule.

Of the 9,000 or 10,000 mutual funds in the United States, a mere several dozen merit the consideration of thoughtful investors. Managed by a handful of maverick mutual-fund families, the meritorious funds stand nearly alone in a vast wasteland. The overwhelming number of mutual funds fail to meet the fundamental criterion of fidelity to fiduciary principles, as pursuit of profit overwhelms responsibility to investors. In the final analysis, almost all mutual funds represent a good idea gone bad.

DESIRABLE MANAGER CHARACTERISTICS

Many try, but few succeed in winning the active management game. Security selectors who attempt to beat the market operate in a brutally competitive atmosphere. Surrounded by highly qualified, highly motivated, highly compensated competitors, the active investment manager struggles to identify and exploit an edge that leads to superior results. Personal characteristics play an enormous role in determining which of the market players prevail.

Great investment managers pursue the business with a passion bordering on obsession. Because the range of influences on markets defies description, nearly every aspect of life provides grist for the investment manager's mill. Active managers who allow the markets to permeate their lives enjoy a greater likelihood of investment (if not personal) success.

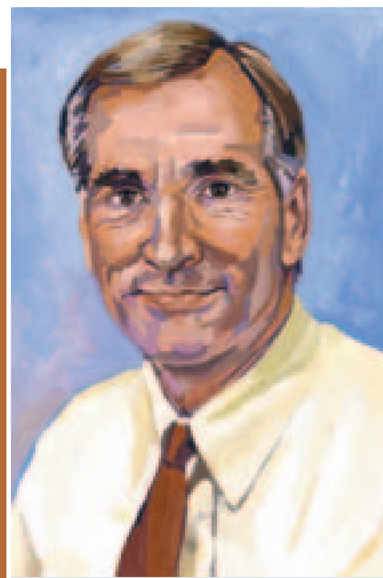
Stamina helps investors keep pace with a nearly inexhaustible supply of inputs. Superior information represents a necessary, albeit not sufficient, condition for superior results. Successful investors work harder to gather greater quantities of data than their unsuccessful counterparts. Information comes from more and better company visits for the green eyeshade investor or from more and better numbers for the quant jock.

Market-beating managers express their insights in concentrated portfolios that differ dramatically from the character of the broad market. Steadfastness proves absolutely necessary when managing a concentrated portfolio. In the inevitable periods that produce disappointing results, managers either hold on, allowing for the possibility of ultimate vindication, or bail out, locking in the certainty of disappointment.

Unfortunately, precious few mutual-fund investors enjoy the opportunity to gather direct evidence regarding a portfolio manager's integrity, passion, stamina, intelligence, courage and competitiveness. The information most necessary for selecting superior investment managers remains inaccessible to nearly every market participant.

External advisors provide little help. Investment advisory services, such as Morningstar, produce rankings based predominantly on quantitative characteristics, doing an elegant job of explaining what was and a lousy job of identifying what will be. Even if fund advisory services focused on the character traits of fund managers, investors might legitimately wonder if the consultants got the "soft stuff" right. The inability of nearly all mutual-fund investors to assess the qualitative aspects of fund management teams produces a nearly insurmountable impediment to investment success.

Mutual-fund shareholders stand to benefit by engaging managers that consider satisfying client interests to be a high priority even if economic incentives dictate

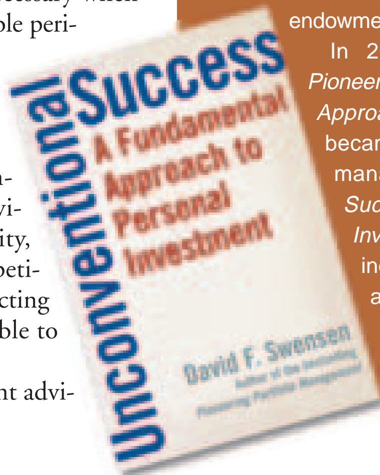


Tom Rhea

David Swensen, chief investment officer of Yale University, stands tall among the best investors of his generation. His remarkable record has served as a benchmark by which other university and foundation investment officers judge their own performances — and the diversification of their portfolios. Swensen, who has a Ph.D. in economics from Yale, was one of the first endowment chiefs to invest in private equity, venture capital, hedge funds, real estate and timber.

Few in the industry have been able to match his blistering pace: Over the past two decades, from July 1, 1984, through June 30, 2004, the Yale endowment produced average annual investment returns of 16.1 percent. In the fiscal year ended June 30, 2004, Swensen's portfolio delivered 19.4 percent — adding another $2.1 billion to Yale's coffers, buoying the total endowment to $12.7 billion. (It's now close to $15 billion.)

In 2000, Swensen published his first book, *Pioneering Portfolio Management: An Unconventional Approach to Institutional Investment*, which quickly became essential reading for professional asset managers. His second book, *Unconventional Success: A Fundamental Approach to Personal Investment* — excerpted here — is written for the individual fundholder. The legendary investor is also a straight shooter: When it comes to money managers, David Swensen calls them as he sees them.



otherwise. The challenges of producing risk-adjusted excess returns pale in comparison to the ease of gathering assets to inflate the management company's bottom line. Increasing assets under management and charging high fees lead to higher corporate income at the expense of lower investment results. By placing risk-adjusted investment returns ahead of personal gain, managers behave ethically.

Perhaps the most powerful incentive for an agent to serve client interests lies in substantial side-by-side investment. Co-investment (say, by a mutual-fund manager in the fund itself) places the agent (fund manager) on the same page as the principal (fund shareholder), as the fact of co-investment actually transforms the agent into principal. Many high quality investment managers pride themselves on "eating their own cooking."

Co-investment works best when fund managers own substantial portions of a portfolio's assets. In situations where fund managers own a less-than-overwhelming position in the fund's portfolio, the rational economic calculus considers the level of assets under management in light of the trade off between higher income from asset gathering and lower investment returns from asset-induced performance drag. In the extraordinarily unusual case of high levels of co-investment, side-by-side positions create a powerful coincidence of interests between managers and investors. Unfortunately, the vast majority of mutual funds contain precious little side-by-side capital.

SOUTHEASTERN ASSET MANAGEMENT

Southeastern Asset Management, sponsor of the Longleaf Partners mutual-fund family, exhibits a number of extremely attractive, investor-friendly behavioral attributes. Begun unpropitiously in April 1987, a scant six months prior to the worst one-day collapse in stock market history, the Longleaf Partners Fund, managed by the team of O. Mason Hawkins and G. Staley Cates, provides a prime example of high-quality individuals devoting their careers to practicing what they preach.

PRINCIPAL ORIENTATION

In the 1998 Longleaf Partners Fund's Letter to Shareholders, Hawkins and Cates articulate ten guiding principles for managing investor assets. The first principle, "We will treat your investment in Longleaf as if it were our own," expresses a commitment to bridge the gap between the principal-shareholder and the agent-manager. The promise of Longleaf Partners to step into the shoes of the mutual fund's shareholders causes the firm's portfolio managers to stand apart from the vast bulk of participants in the mutual-fund business. For example, as part of the firm's commitment to serve investor interests, Southeastern cites its decision not to accept soft-dollar kickbacks, a policy that the firm called "unique in the industry." By articulating the guiding tenet that Southeastern's managers strive to act in investor interests, the firm sets the stage for the investor-friendly principles that follow from that premise.

CLEAR STRATEGY

A firmly held, carefully expressed investment strategy contributes mightily to the likelihood of portfolio management success. The investment managers at Longleaf Partners promise to "choose our common stock investments based on their discount from our appraisal of their corporate intrinsic value, their financial strength, their management, their competitive position, and our assessment of their future earnings potential." Using a price-to-fair-value ratio to measure the relative attractiveness of individual securities, Longleaf portfolio managers view the market from the perspective of a strict valuation discipline. When well-managed companies trade at a significant discount to fair value, the managers express considerable enthusiasm for their portfolio's prospects, encouraging shareholders to commit funds. When discounts to fair value shrink, managers exhibit caution, allowing cash positions to rise.

During the early years of the firm's history, the thoughtful approach to markets worked well. Longleaf Partners Fund produced returns of 15.3 percent per annum from the April 1987 inception to December 1995. The result outperformed the S&P 500's 12.6 percent per annum return for the same period, satisfying aspirations of investment manager and mutual-fund investor alike.

During the next five years, the story changes, as the Southeastern portfolio managers labored under the pressures produced by an underperforming contrarian portfolio. In the twelve months ending March 2000, the Longleaf Partners Fund lagged the S&P 500 by nearly 27 percentage points. In the previous five years, the annual deficit relative to the S&P 500 amounted to more than 12 percentage points per year. Few investment managers proved more out of synch than Southeastern with the new era.

Shareholder questions from the firm's 1999 Annual Report illustrate the pressures confronting Southeastern. "Is something wrong at Longleaf?" "Why are you avoiding the Internet growth stories?" "Will Longleaf ever invest in technology?" "Why aren't you worried about your results?" Even though Hawkins and Cates publicly answer the last question by stating that "the best collection of assets we have ever held, at the best prices . . . should produce significant future returns," the senior executives of Longleaf Partners must have lost at least some sleep over the firm's performance. The excesses of the Internet mania turned a once-distinguished record of superior performance into an apparently run-of-the-mill showing.

Longleaf Partners Fund's inability to match the manic bull market returns caused substantial numbers of investors to defect. Helping to define the market top, Longleaf's departing investors left at the moment of maximum opportunity.

In a shameful side show to the main event, Morningstar contributed to the exodus of investors from the Longleaf Funds. In spite of Longleaf Partners' dramatic underperformance, even as late as June 1999, the fund enjoyed a five-star rating from Morningstar. Yet, with perfectly-pathetic-poor timing, in December 1999, Morningstar reduced the Longleaf Partners Fund rating to a middling three stars. Just when investors needed the forward-looking vision to maintain their position, Morningstar's rear-view-mirror image showed them the door.

Even though Longleaf Partners Fund could no longer serve the investors that departed, the firm rewarded investors that remained for maintaining a tough, out-of-the-mainstream position. From the end of the first quarter of 2000 through the end of 2003, the Fund returned nearly 16 percent per annum, outpacing the S&P 500's negative return by 22 percentage

points annually. More important to the firm's long-term fund shareholders, April-1987-inception-to-date performance exhibited a dramatic edge relative to the S&P 500, trouncing the passive benchmark by an annual margin of 3.9 percent. Hewing to a sensible, carefully considered set of investment principles, the wild ride notwithstanding, ultimately produced substantial rewards for both Southeastern and its loyal band of shareholders.

LONG-TERM FOCUS

Longleaf portfolio managers "invest for the long term, while always striving to maximize after-tax returns and to minimize business, financial, purchasing power, regulatory and market risks." Instead of playing a high-turnover, frenetic, beat-the-market game that inevitably imposes a sizable tax burden on investors, the investors at Southeastern serve shareholder interests by managing assets in a tax-sensitive fashion.

PORTFOLIO CONCENTRATION

By recognizing the "importance of concentration," portfolio managers "choose only (the) best ideas," ensuring that positions "have a meaningful impact on the overall portfolio." Rejecting the cynical, closet-indexing ploy practiced by a host of asset-gathering mutual-fund complexes, the investors at Longleaf Partners take the business risk of constructing a less-diversified collection of positions. Concentrated portfolios require evaluation over a longer time horizon than do more broadly diversified offerings. Because performance depends on a relatively small number of positions, the deviation between portfolio results and market returns looms large. Yet, with superior active managers, concentration pays huge dividends, as astute stock selection influences results in a dramatic fashion, thereby increasing the likelihood of satisfying investor hopes for superior performance.

STABLE CLIENT BASE

Southeastern recognizes the importance of attracting sophisticated mutual-fund investors that share the firm's investment philosophy. If performance-chasing hot-money players abandon the Longleaf funds at an inopportune time, the fund withdrawals damage the exiting shareholders, the remaining shareholders and the Longleaf Partners portfolio managers. Little wonder that Hawkins and Cates emphasize the importance of populating the firm's investor base with individuals who operate with a sufficiently long time horizon.

Fully five years prior to the mutual-fund scandal of 2003, Longleaf Partners articulated the principle of "discouraging short-term speculators and market timers." In an action that brings shame to nearly all of the rest of the mutual-fund industry, Hawkins and Cates wrote that "(d)uring 1998, we worked closely with third party clearing firms and our transfer agent to identify market timers. We have compiled a large list of investors and advisors who are prohibited from trading in any of our funds. Inflows from a person whose time horizon is less than three years do not benefit our investment partners." While managements of other mutual funds cut deals for sticky assets with market-timing vermin, Longleaf Partners strove to eradicate the pests.

FAIR FEE ARRANGEMENTS

Sensitive to the fee-induced erosion of investor assets, Longleaf Partners states that the firm "will not impose loads, holding periods, exit fees, or 12b-1 charges." The 1998 Annual Report notes simply that "(l)ow expense ratios and no surcharges are in shareholders' best interests," concluding that "(w)e will not raise or add fees." Amazingly, Southeastern on occasion takes the extraordinary step of reducing fees. In September 2003, Longleaf Partners International Fund announced a decrease in annual management fees from 1.5 percent to 1.25 percent for assets in excess of $2.5 billion, suggesting that "it is fair that we share some of the economies of scale with our partners." The reduction in fees clearly represented no ploy to attract assets on a discounted basis. Less than six months later, Southeastern closed the International Fund to new investors.

SUBSTANTIAL CO-INVESTMENT

The firm's principals demonstrate conviction by investing substantial personal assets side-by-side with investors, stating "(w)e will remain significant investors with you in Longleaf." Co-investment at Southeastern registers at a truly impressive level. At the end of 2003, Longleaf trustees, employees and their relatives owned more than $400 million of Longleaf fund shares, representing around four percent of the firm's $10 billion of mutual-fund assets. Southeastern Asset Management's prohibition on employee investments outside of the firm's mutual funds reinforces the principal orientation of the firm.

LIMITS ON ASSETS UNDER MANAGEMENT

In another remarkably investor-friendly policy, when Southeastern Asset Management sees diminished investment opportunities, the firm closes its funds to new investors. In September 1995, citing "our inability to find qualifying businesses managed by capable individuals at prices sufficiently discounted from our corporate appraisals," Mason Hawkins and Staley Cates closed their flagship Longleaf Partners Fund. As evidence of the lack of investment opportunity, cash constituted 26 percent of the Fund's $1.76 billion in assets.

At the same time that Longleaf Partners closed with less than $1.8 billion in assets, the world's largest actively managed mutual fund — Fidelity Magellan — boasted more than $50 billion in assets. Even though Magellan took the size prize by a country mile, Longleaf led in the performance derby by a respectable margin. Trailing five-year performance for Memphis-based Longleaf clocked in at 24.3 percent, comfortably ahead of the Boston-based Magellan result of 22.9 percent. Both actively managed funds handily beat the five-year S&P 500 Index return of 17.2 percent.

Had Southeastern decided to market the 1995 Longleaf Partners Fund track record, the firm certainly could have amassed tens of billions of dollars in assets under management. With each ten billion dollars contributing a potential $75 million in revenues to the management company, Hawkins and Cates required only fifth-grade math to understand the impact on their personal finances. Yet, instead of pursuing personal profit, the fund managers closed their flagship fund, reducing

the impact of size-induced performance drag.

In the letter announcing the decision to close the fund, Hawkins and Cates note that investors had benefited from economies of scale during the fund's early stages of asset growth. At inception in 1987, Longleaf Partners Fund's expense ratio stood at 1.50 percent. By 1995, the ratio declined to 1.06 percent as a result of efficiencies associated with managing a larger pool of assets. As part of the rationale for closing the fund, the portfolio managers observed that further increases in assets under management will produce "proportionately much less benefit" to the expense ratio, once again illustrating Southeastern's focus on shareholder interests.

The reduction in the expense ratio represents another example of Southeastern placing investor interests above the profit motive. Instead of allowing economies of scale to drive down expenses, the managers could have quietly maintained the percentage-of-assets charges, generated greater cash flow and garnered greater profits for themselves. Instead, Southeastern transferred a significant portion of the benefits of increasing scale to its customers.

Slightly more than three years after closing Longleaf Partners Fund, in October 1998, Southeastern reopened its flagship offering, noting that "investment opportunities exceeded the Fund's cash levels and new inflows could enhance all shareholders' returns." The door to new investors closed again, less than a year later in June 1999, as Southeastern found "few new investments that meet the Partners Fund's criteria." Continuing its opportunity-sensitive policies, the Longleaf Partners Fund reopened in February 2000 to facilitate acquisition of "compelling" investments.

The years during which Southeastern closed the Longleaf Partners Fund certainly constrained the size of assets under management. At the end of 2003, the fund held 20 stocks in a portfolio valued at $7.7 billion. In contrast, the Magellan Fund owned 224 stocks in a portfolio of $68 billion. Yet Southeastern's investment disciplines, including portfolio concentration and asset growth restraint, paid off in a big way. At year-end 2003, trailing five-year returns for Longleaf Partners Fund amounted to 10.8 percent per annum. Over the same period, the bloated Magellan Fund, with its too-broadly-diversified portfolio, returned –1.1 percent, failing to match the –0.6 percent annual return of the S&P 500 Index.

SHAREHOLDER COMMUNICATION

Southeastern's final principles deal with commitments to shareholder services and candid communication. While asset-gathering mutual-fund companies invariably provide easy access to offering documents that prospective shareholders must receive prior to making an investment, auxiliary documents that contain sensitive information — such as the Statement of Additional Information (SAI) — frequently prove more difficult to obtain. Consistent with Southeastern's broad-based investor-friendly policies, the firm's commitment to candid communication with shareholders allowed access to the SAI with a simple click of the mouse.

SUMMARY

Southeastern's status as a privately held independent company proves critical to the firm's ability to serve investor interests. Were Southeastern Asset Management a subsidiary of a financial services conglomerate, the firm would face pressures to contribute to the parent company's bottom line. Were Southeastern a publicly traded company, the firm would owe a duty to provide profits to shareholders. Only when operating in the context of a privately held, portfolio-manager-controlled, independent company do managers possess the ability to consider serving the interests of investors without worrying about the implications for the income statement. Independent companies enjoy the opportunity to choose the degree to which the firm serves investor interests or generates corporate profits.

Southeastern Asset Management exemplifies every fundamentally important, investor-friendly characteristic conducive to active management success. Portfolio managers exhibit the courage to hold concentrated positions, commit substantial funds side-by-side their shareholders, limit assets under management to reasonable levels, show sensitivity to tax consequences of transactions, set fees at reasonable levels and even shut down funds in the face of diminished investment opportunity. Even though all of the signs point in the right direction, investors still face a host of uncertainties regarding Southeastern's future active management success.

Because people constitute the core of the investment management process, the important questions regarding future performance revolve around personnel. How long will Mason Hawkins and Staley Cates continue to devote the time and effort necessary to produce superior investment results? Have the senior members of the management team attracted, trained and retained high quality younger people? Are the economic rewards distributed fairly among the professionals responsible for producing investment returns? Answering critical questions regarding the experience, motivation and engagement of the investment team requires a depth of organizational understanding unavailable to the average mutual-fund investor.

Finally, successful mutual-fund investors must understand themselves well enough to know if they possess the conviction to maintain fundamentally sound, yet out-of-favor positions. The nearly 30 percent of assets that investors withdrew from Longleaf Partners at the peak of the market in late 1999 and early 2000 doubtlessly damaged portfolios thrice. First, exiting investors paid taxes on realized gains. Second, the leave takers suffered poor relative past performance and missed good relative prospective results. Third, departing players likely chased a recent hot-performing fund just as results were about to turn cold. Identifying a winning fund proves helpful only if the investor demonstrates sufficient staying power to reach the finish line.

Signing up for any active management program, even one as attractively positioned as Southeastern Asset Management's, requires a giant leap of faith. Investors must believe that the future will resemble the past, all the while recognizing the inevitability of change. Fund managers grow old, disengage, exhibit greed, fail to plan for succession. Even if the names on the door remain the same, the firm that produced the top-of-the-charts ten-year record differs from the firm that will produce the next decade's results. People change.

This material should be preceded or accompanied by a Prospectus. Returns do not reflect the deduction of taxes that a shareholder would pay on Fund distributions or the redemption of Fund shares. Average annual total returns for the Longleaf Partners Fund and the S&P 500 Index for the one, five and ten year periods ended June 30, 2005 are as follows: Longleaf Partners Fund, 2.82%, 11.18%, and 13.13%; S&P 500 Index, 6.32%, (2.37%), and 9.94%. Fund returns and those of the unmanaged S&P 500 Index include reinvested dividends and distributions. Current performance may be lower or higher than the performance quoted herein. Past performance does not guarantee future results, fund prices fluctuate, and the value of an investment at redemption may be worth more or less than the purchase price. Please call 1-800-445-9469 or view Longleaf's website (www.longleafpartners.com) for more current performance information, or for a current copy of the Prospectus, which should be read carefully before investing to learn about the investment objectives, risks, charges and expenses of the Longleaf Partners Funds. Southeastern's Code of Ethics requires all employees to limit their investment in equity securities to the Longleaf Partners Funds, unless granted prior clearance.

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