Donald Yacktman and the Conceit of Active Management

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Yacktman is known as a “value” stock manager, in the old-school sense of the word. That is, he convinces investors and advisors that he is uniquely talented at finding “undervalued” or mispriced stocks among the many thousands available and that by doing so can beat the market (the average investor) over time.

In return for their faith, investors can expect a turbulent and unpredictable ride—with disappointment being the much likelier result than reward. As evidence, I present the history of the Yacktman Fund. I had no idea as I prepared last month’s Asset Class article that the Yacktman Fund and its sister, the Yacktman Focused Fund, were the new darlings of the mutual fund world. Not only do they rise to the top of past five- and ten-year Morningstar screens, but they also trounce their nearest competitors by a wide margin. Bill Miller, Ken Heebner, Bruce Berkowitz, Bill Nygren, Bill Gross? All old news. Fallen stars. Today, it’s all about Donald Yacktman.

A Star Is Born, but Faith Is Challenged

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Prior to his debate with Sinquefield, the Yacktman Fund trailed the S&P 500 by 20% over the previous three years. Yet Yacktman’s reputation as a star manager remained firmly intact as fund assets continued to grow and by the end of 1997 reached $1.1 billion, despite performance that continued to lag further and further behind the index.

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Faith? Only faith can explain why investors poured so much new money into Yacktman’s fund in 1997, when it trailed the index by 15.1%. The total opportunity cost (what they gave up by not investing in a “dumb” index fund) for those who were in for the full ride was now 57%. Ouch...but it got worse.

Many investors began to believe Yacktman was a fraud. In 1998, his fund’s assets dropped 72% after performance lagged the index by 28%. In 1999, they dropped another 65% after the fund trailed the index by an astounding 38%. By the end of 2000, despite a very good year in which Yacktman actually beat the S&P 500 by 23%, the fund assets dropped to a low of $70 million.

As the box in Chart 1 shows, over a total of seven years and nine months the performance of the Yacktman Fund trailed the market by more than 250%! Worse, the fund even trailed an index of U.S. large value stocks by almost 220%.

Try to grasp what really happened here: Investors put their faith in a star manager who concentrated his bets on a handful of “undervalued” stocks (usually no more than about 40), realized returns significantly below what they could have earned in a very low-cost, passively managed S&P 500 index fund, and then bailed out before performance recovered.

Where do you think most of that money went? Maybe to another star manager? And why do you think the new manager was a star? Because he or she had been riding the large growth, technology, Internet stock escalator to the top of the 1990s “bubble,” perhaps? Any guess as to what happened next?

This is the vicious cycle of active management. Buy high and sell low doesn’t just happen with individual securities. For individual investors, it happens more often with funds. In the Yacktman case, this behavior was either directed or facilitated by professional advisors who brought in 70% of Yacktman’s assets.1

For 401(k) plan participants, this buy-high, sell-low damage is compounded by the fact that even if they want to be patient with a fund manager, too often the geniuses selecting the funds for the plan pull the plug on a fallen star and replace him or her with a new star. This cycle repeats itself over and over again. You think Social Security has problems? Wait until all the boomers with 401(k) balances try to live off the remains of this madness.

The Star Rises Again, but Where Are the Faithful?

Things got so bad for Donald Yacktman that some of the directors of his fund wanted to fire him in 1998. One was a longtime friend, who was also working for Yacktman’s management firm, and one was an independent director. They felt that Yacktman was violating the terms of the fund’s prospectus and investors deserved to know. Imagine that. In any case, after the ensuing proxy battle, the remaining shareholders backed Yacktman and the troublemaking directors were booted out. As you can see in Chart 1, performance and assets continued to go south.

The second quarter of 2000 saw a dramatic turnaround in Yacktman’s fortunes (most of his investors were long gone, however, as Morningstar smacked the fund with a one-star rating). The combination of the steep decline in the growth stocks that had powered the S&P 500 during the second half of 1990s, the recovery of some of Yacktman’s concentrated deep “value” stock picks, and unexplained market timing moves (most likely cash inflows Yacktman was reluctant to invest in a rapidly falling market) resulted in market-beating performance for the next five years.

It was only after this stellar performance that Morningstar once again awarded Yacktman five stars. It didn’t last, though. For the next four years (2005-2008), the fund investments lost 12.5%. Morningstar then took back two of its stars and investors took back more of their assets, leaving the fund with a paltry $297 million in assets.

Let’s recap. Anointed a star manager in 1991, Yacktman underperformed the average investor and a highly diversified, passively managed value index by huge margins in the 1990s. Investors left in droves. He then performed exceptionally well for a stretch when assets in the fund and its Morningstar rating were at their lowest points. Yacktman then proceeded to lose money for the remaining investors over four more years but was awarded Morningstar’s coveted five stars nevertheless.

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Five Star Faith (or Déjà Vu All Over Again?)

The Yacktman Fund had a very bad start in 2009 (down 19% in the first two months) but finished the year strong. Assets climbed to a new high of $1.4 billion. On faith and momentum alone (the fund once again trailed the S&P 500), the fund attracted another $2 billion in assets in 2010 and has added another $2 billion this year.

Chart 2 shows the growth of assets and the relative performance of the fund since 2000. Note the change in Morningstar star ratings each year. It’s said a picture’s worth a thousand words, and that’s true here. You can see rearview mirror investing at its worse. Any advisor bold enough to have recommended the Yacktman Fund to a 401(k) plan in the early 2000s would have been laughed out of the office. In 2010-2011, the advisor would have been kicked out if he hadn’t included the fund.

How much of the $4 billion that has flooded into the Yacktman Fund since 2009 has resulted from advisors’ addition of the fund to 401(k) lineups is anyone’s guess. What we do know is that few 401(k) participants, or anyone for that matter, benefited from Yacktman’s good years.

What we don’t show in the chart is the constantly changing investment style of the fund over time. Yacktman has shifted back and forth from a small value manager to a mid cap and large cap blend (growth and value) manager to a large cap value manager. In the past he refused to buy technology companies, because he didn’t understand them (mimicking Warren Buffett). Today six out of 38 total holdings are tech stocks.

So what is Yacktman’s style? Growth, value, large, or small? Is he a market timer? Does he now suddenly understand technology companies? His cavalier and arrogant response? “Investors know my strategy. They know we may be concentrated in different sectors and stocks than everyone else, depending on what we see.”

That’s a strategy? Tell that to your average 401(k) investor or even most advisors who recommend his fund and you’re likely to get back a puzzled look. It’s the returns, stupid. A prominent New York financial planner stated in 2001 that he took clients out of Yacktman’s fund in 1998 purely because of performance. He also said, “Yacktman’s stocks were blowing down and his style was out of favor. My clients just couldn’t stand the headaches of staying with him anymore.” So who’s the expert here? Should I just rest my case and say that Morningstar ratings, which are so heavily based on past performance, are the be all and end all of most “professional” investment advice in this country?

Here’s the bottom line on fund manager stargazing and the faith it requires. Stars are competing every day against other stars and millions of ordinary investors to find “undervalued” stocks. This old-school method simply doesn’t work anymore. So all that’s left are guesses, bets, and faith. Undervalued stocks don’t exist, because competition has resulted in the best price based on all known information. Markets are efficient.

Concentrated Bets Win the Star Lottery

In the modern world of investing, therefore, “undervalued” stocks are figments of overconfident and delusional imaginations. What makes Bill Miller, Bruce Berkowitz, or Donald Yacktman a star today or a goat tomorrow is portfolio concentration. They are making big bets on a relatively few stocks and hoping they’re right long enough to attract four or five stars from Morningstar and a boatload of assets from naive investors. A close look at the change in net assets for almost any fund run by a star manager will reveal a pattern similar to that of the Yacktman Fund.

The only thing constant in this equation is the fee to the manager. In the meantime, investors (often with the “help” of undisciplined advisors) are jumping in and out of the funds as their faith waxes and wanes. This is especially true of everyday working Americans with long-term time horizons who are saving for retirement, such as those in 401(k) plans.

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Worse perhaps are the trustees of foundations and endowments who compromise portfolio growth, and payouts to beneficiaries, because of their faith in stars. These trustees are often highly educated and successful professionals—many with years of experience in the financial industry. They should know better.

With almost $10 billion in assets under management, Yacktman will walk away with over $63 million in fees this year. Considering how so few investors benefited during his good years and that so many more suffered through his many bad years (relative to a simple S&P 500 index fund), does he deserve this paycheck? Evidently Morningstar and thousands of advisors think so.

**Real Value**

After all the bets of active investors, advisors, and money managers are placed and egos are satisfied, what remains in stocks is simply risk. Value and small cap stocks are riskier than growth and large cap stocks. Therefore, risk-based asset class strategies, like those used by Equius Partners, are a superior alternative to placing faith in star managers.

The invention of highly diversified and passively managed asset class funds offers investors the opportunity to realize the higher expected returns of (higher-risk) value stocks without the “help” of star managers. To go along with their S&P 500 index fund, Sinquefield’s DFA introduced its U.S. (and international) large and small value asset class mutual funds in the early 1990s for that purpose.

From their inception through the first quarter of 2000 (when the dot-com craze peaked), those funds returned 13.9% and 15.4% annually, respectively, compared to 6.6% for the Yacktman Fund. Another way to look at it is that DFA captured the pure return (and risk) of U.S. value stocks by investing in more than 1,500 different securities using a passive, or indexed, approach while Yacktman played around with the wrong 40 or 50.

Even with Yacktman’s off-the-charts performance since 2000, including an outstanding year so far in 2011, he’s barely ahead of a 50/50 mix of the passively managed DFA funds. (At the end of 2010—after more than 17 years of trying—he was trailing the value asset class fund mix.) Star manager? Really? How many investors in Yacktman’s fund actually realized anywhere near that return? Maybe no one.

**Conclusion**

Yacktman has the right to run his funds any way he likes (or at least according to the terms of the prospectus). The fact is, a theoretical investor who started with him and stayed for the whole ride would have done quite well. Was it worth the much higher risk that concentrated gambles require? Not in our book. That risk is compounded by bad investor behavior, and fund managers have no influence over that.

Investment advisors who use actively managed funds and have discretion over client assets, on the other hand, do. If it’s true that the majority of the assets in Yacktman’s funds are controlled by advisors, these advisors are responsible for a) betting on stars and b) the buy-high, sell-low foolishness we see in the cash flows. The excuse that “my clients just couldn’t stand the headaches of staying” is an amateur cop-out not worthy of a financial planning or advisory fee.

It’s not Morningstar’s fault either. Yes, its star rating system is seriously flawed, but it looks like it is taking steps to correct the system with the new Analyst Rating. Morningstar gathers data. It’s up to advisors and investors to figure out how to use it profitably, if at all.

And, of course, individual investors, whether they use an advisor or not, are ultimately responsible for their own decisions and behavior. Educate thyself or don’t complain. Otherwise, all you have is faith.

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<th>Key Points:</th>
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<td>• Today the case for active management rests solely on the existence of, and faith in, “star managers.”</td>
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<td>• A star manager today is likely to be a goat tomorrow.</td>
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<td>• Star managers make risky concentrated bets in the hope of receiving a four- or five-star fund rating.</td>
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<td>• Due to buy-high, sell-low behavior, average fund investors realize a fraction of the star’s manager’s long-term return.</td>
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<td>• Value stocks outperform because they are riskier, not because they are “undervalued.” Measured against proper benchmarks, stars become average.</td>
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<td>• The existence of structured, highly diversified, and passively managed asset class funds make star managers (and active management) irrelevant.</td>
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For another example of the trials and tribulations of star managers and their investors, see “Time to Sell Fairholme?,” The Wall Street Journal, 11/7/2011.

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This information is for illustration purposes only and is not a recommendation of particular mutual funds. Source: Morningstar Principia mutual fund database. Past performance is no guarantee of future results.