

Guns N' Leeches

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No doubt about it, it's fall. There's a chill in the air, leaves are turning and supermarket aisles are overflowing with candy. Ghouls and ghosties will soon be parading down your street.

And when it comes to trick or treating, my two kids have taken very different approaches over the years ...

The oldest, who's always hated costumes, would don his at the last possible moment and strip as soon as the last Caramello dropped into his bag. **He knew the costume was the price of admission**, but he would work the loopholes hard - sling on an aloha shirt and a camera and go as a tourist, for example.

My youngest, in contrast, as a toddler *HAD* to wear the correct gear to match whatever video he was watching at the time. **If you looked in his closet you'd have thought that he was a member of the [Village People](#)**. To this day, he's happy to dress up, as long as it doesn't involve a tie and jacket.

But whatever their differences over Halloween *costuming*, **both boys were in full agreement as to what constituted "good candy" ([Snickers](#)) versus "bad candy" ([Smarties](#))**. And that meant that the trick or treating post-mortem involved counting and sorting (even graphing!) the candy to gauge each Halloween's performance.

Interestingly, as the end of the year draws ever closer, **investors will be going through a similarly ghoulish process of "analyzing the haul."** And here, as well, there will be little disagreement over what constitutes "good" vs. "bad" performance. However, not all bad returns elicit the same client reaction.

Guns N' Leeches

Generally speaking, bad performance falls into one of two categories: **"Death by Smoking Gun"** or **"Death by a Thousand Leeches."** Both are bad news (as an old colleague was fond of saying, "Mr. Market likes to give the maximum amount of people the maximum amount of pain"); however, **smoking guns, deservedly or not, tend to**



be preferred by clients (more about why in a minute).

The smoking gun scenario is straightforward - a stock (or two or three) blows up spectacularly. The rest of the portfolio may be fine, but performance has been killed.

Death by leeches, by contrast, means bleeding 10, 20, 30 basis points of relative performance a day, for days on end. If it goes on long enough, the portfolio (and the business) can bleed to death. There's no obvious place to apply a tourniquet, and, unlike the smoking gun outcome, no obvious place to point a finger.

Think back to 1999 and **the Dot Com craziness that resulted in an entire generation of deep value managers hemorrhaging assets**, many of whom, convinced that the rules of investing had permanently changed, simply retired.

The leeches typically arrive in strong up markets, or when one or two sectors in the index are on fire (sectors in which one's portfolio is underweight, naturally).

Faced with the performance doldrums, good managers do the sensible thing - make sure there's no leak in the hull, remove whatever barnacles may be slowing down the ship, and wait for the wind to start blowing again. For investing professionals who see themselves as active, heroic decision makers, it can lead to feelings of helplessness, and a potentially fatal itch to do something, *anything*.

But if death by leeches drives us money managers crazy, it drives our clients *insane*. **A money manager is more likely to get fired for leeches than for smoking guns.**

Why? **There's a tendency to overweight bad performance when it comes slowly and to cut too much slack when it happens in one quick bang** - even if the cumulative hit to performance is the same.

So why the bias against the leeches?

1. **Leeches can't be trusted.** Leeches don't reveal a clear problem, just the absence of relative performance. **The underperformance is indisputable; the cause is harder to prove.**

And though the portfolio holdings may not have changed much, the underlying businesses haven't deteriorated, and there haven't been any blow ups, **clients feel there *MUST* be a better reason for the lag** ... a reason that the manager must be doing a good job hiding or is too stupid to figure out.

There's a fear that something is hidden that will later spring up, and no one wants to look foolish then, for not firing the manager when they had the chance.



2. **Leeches are hard to get rid of.** Unlike a slow death, a smoking gun - with its one-time hit to the portfolio, rock-solid reasons for underperformance and opportunity for a quick disposal of the corpse - means that once taken care of, life and relative performance can return to normal.

The smoking gun provides what seems a simple, clear means of evaluating whether or not the investment process is broken. We can see whose fingerprints are on the gun and under what pretext it was smuggled into the portfolio.

3. **Leeches are icky.** Pardon the chick talk, but you know what I mean. Death by a thousand leeches is slow, boring and unsatisfying. **It's like sitting in a leaky boat that drops farther and farther below the water line** while the crew frantically searches for the source.

Guns on the other hand, even when they go off in the wrong direction, are cool. Loud and painful perhaps, but they make for a good story.

Whether sorting treats or evaluating investment performance, a Smartie is not a Snickers. And regardless of how one or the other ends up in your candy sack, nobody likes coming up short. **But beyond the losing numbers themselves, it's important to remain unbiased about the sources of bad performance.**

If it's true that under the leech scenario we look too hard for obvious culprits, it's also true that in the case of the smoking guns, we don't look hard enough. **To paraphrase Freud, sometimes a leech is just a leech.** And sometimes a smoking gun means a killer is still loose in the house.

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