



## Letter to the Editor: Identifying Skillful Managers

May 27, 2008

The following letter is in response to two [letters to the Editor](#) published last week.

Dear Editor,

Ian Post asked for an explanation for why Marketocracy's active management process "seems not to be adding alpha over the past five years" because we have lagged the mid-cap core benchmark for that period. If the fund was limited to mid-cap core stocks I would agree.

But, I think investing skill is demonstrated if the stocks in which we invest outperform the universe of stocks from which are allowed to choose. While Morningstar does indeed show us behind the mid-cap core benchmark for the past 5 years, it also shows us ahead of the S&P 500 for the same period. Which benchmark better reflects the universe of stocks from which the fund can choose?

The prospectus says the fund invests in stocks of any size, seeking to outperform the Standard & Poor's 500 Index. The Fund is not constrained by any particular investment style. At any given time, the Fund may tend to buy "growth" stocks, "value" stocks or both. Clearly, the fund's universe is not limited to mid-cap core.

The S&P 500 is the better benchmark for us because it covers 80% of the market value of the entire universe of U.S. stocks. In addition, since the most widely used passive products are tied to the S&P 500, it is the benchmark an actively managed core fund needs to beat to show that it can be competitive with an index fund.

Also, last week, Brent Bentrin brought up the idea of defining a manager's style in terms of a set of passive indexes so that you can use twenty years of data (about the indexes) to assess the manager. However, when I look at Mr. Bentrin's chart, I don't see how it is obvious that the best fit benchmark for our fund is the Surz Small Growth Index as he says it is. Apparently, this is important because Mr. Bentrin seems to say that if the best fit benchmark is anything other than the best performing asset class then we have not exhibited skill because we could have done better. I strongly disagree.

In my coin-flipping analogy, trying to identify the best performing asset class would be like trying to pick someone who is going to flip 10 heads in a row. As we saw from the coin-flipping results, you don't have to be able to do that in order



to beat the averages. By running a diversified fund that does not make big bets on any single analyst or asset class, we have a better chance of beating an index fund than if we bet everything on the single analyst with the best track record or the single best performing asset class. Mr. Bentrin's chart shows that indeed we have always held a mix of asset classes.

The acid test of whether active management can be a practical alternative to an index fund is whether it delivers a better return after all fees. An index fund tied to a broad market benchmark such as the S&P 500 reflects the results of the average investor. If skilled investors exist, they ought to outperform the average investor.

It would be easy to choose between investing alongside the average investor or a group of skilled investors with a diversified portfolio, if you had confidence that the group was truly skilled. I realize that the threshold of proof in terms of alpha and length of track record required to instill confidence is different for each person. But after nearly seven years, our track record is providing mounting evidence that investment skill exists and that it can be practically harnessed.

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