



Letter to the Editor

June 10, 2008

The following letter is in response to a [letter](#) published last week.

Dear Editor:

Last week Henry Schwarzberg questioned whether the S&P 500 is an appropriate benchmark for our mutual fund. In his words, "The fund's market capitalization, price to book, and holdings clearly constitute a materially different sub-set of the same broad market and the fund needs to be measured against an appropriate index that reflects that."

Mr. Schwarzberg makes an assumption that the stocks we currently hold reflect the universe of stocks from which we can choose. While our fund can invest in all market caps, all style boxes and even non-U.S. holdings, we are not required to make investments in every sub-set of our universe. The fact that our current holdings are different from those of the S&P 500 is not because they are outside of our universe, but because our process has steered us elsewhere *at this time*. At some point, large-caps will have another day in the sun and our process will migrate our portfolio there.

Over the last six and a half years, Lipper has categorized our fund as multi-cap core, mid-cap growth, small-cap value, small-cap core, and currently mid-cap growth. The [chart](#) from Brent Bentrim's returns based style analysis, which was published three weeks ago, confirms that our fund's style mix has changed a lot over time. Because our fund's mix of sectors and styles changes, it is doubtful that any single index or blend of indexes will have a high R-square with our fund over the long-term.

The ability to change the fund's style and sector mix is key because the market is always changing. As styles and sectors move from undervalued to overvalued, investors need to adapt. Fund's that must stay in a box, even when it is overvalued, are destined to disappoint their shareholders.

We draw from a large talent pool to recruit skilled investors to take advantage of the new opportunities that arise when the market changes. Measuring our fund against a series of specific benchmarks, depending on our actual holdings, does not attribute any value to our process of choosing to be in the right sectors and styles at the right time.

Our fund is geared to an investor whose primary criterion is beating a broad-based market index, and the S&P 500 is as good a benchmark of the broad



market as any.

In the context of the active versus passive debate there is also a theoretical reason why the S&P 500 is the appropriate benchmark.

If the managers we have identified possess above average investment skill then the proof will be that they get better returns than an average investor, whom we presume possesses average skill. So, to prove that we are finding skill, we need a way to estimate the return of the average investor.

If we could ask all U.S. Equity investors to report their returns it would be a simple matter to calculate an average. But, that is not possible. I credit Bill Sharpe for coming up with the key insight that leads to a practical alternative.

Imagine a stock market in which there are only 100 investors and three stocks. Company A issues 1000 shares which trade at \$50 per share. Company B issues 10,000 shares at \$4, and Company C issues 100 shares at \$100 each.

Although each of the 100 investors owns different amounts of each of the three stocks, we know that as a group they must own all of the shares outstanding of all 3 companies. Therefore, on average, each investor must own 10 shares of A, 100 shares of B, and one share of C. In other words, the average investor's portfolio consists of a pro-rata share of every outstanding security. As a result, we can infer that the average investor owns a portfolio that looks a lot like a market-cap weighted index of all tradable securities.

The S&P 500 covers 80% of the market cap of all U.S. securities so it is a good approximation of the return received by an average investor of average skill. So, although it is not perfect, it is an appropriate benchmark for answering the question of whether we are finding skill.

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