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Facing the Future with Optimism and Courage
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Out of Focus

One of the best examples of the danger of chasing past performance is the CGM Focus Fund (CGMFX). This fund was created in 1997 by legendary manager Ken Heebner, a self-described contrarian investor - the term used to describe someone who invests against the prevailing market sentiment. CGMFX underperformed the S&P 500 from 1997 to 2000 because Heebner avoided tech and dot-com stocks. When the dot-com bubble burst, his fund not only emerged unscathed, but it became one of the hottest and most talked about mutual funds. From 2000 to 2007, CGMFX didn't just outperform the S&P 500, it outperformed every other actively managed mutual fund. In a 2009 article in The Wall Street Journal, Heebner noted: *"A huge amount of money came in right when the performance of the fund was at a peak. I don't know what to say about that. We don't have any control over what investors do."*

Every day the financial media bombards us with investment industry hype and propaganda that touts past performance. Few investors knew of CGMFX until it was universally praised in the financial media. In December 2007, CNN Money touted it as a "standout mutual fund" – *"Veteran investor Ken Heebner has long held to a strategy that on its surface is simple: He looks for opportunities wherever he can find them and then pursues them aggressively, quickly diving in and out of stocks of all sorts...His CGM Focus fund has rocketed more than 60% since the beginning of the year, thumping the S&P 500 stock index by some 57 percentage points. Even more impressive, CGM Focus has chalked up astounding average returns of 25% a year over the past ten years...Heebner's bets have paid off more often than not, making him a gutsy master we'd trust with our money."*

Kiplinger's magazine touted the fund in August 2008 – *"A standout is CGM Focus (CGMFX), a member of the Kiplinger 25. Manager Ken Heebner's brilliance at picking investment themes and the stocks that go best with them is in full bloom with this fund."*

Heebner appeared on the cover of the June 8, 2009 issue of Fortune magazine, which anointed him as *"America's Hottest Investor"* adding - *"this mad genius is arguably the best fund manager of our time."*

The acclaim was well earned. CGMFX generated an annualized average return of more than 18% during the first decade of this century - known as the "lost decade" - in which the S&P 500 lost an average of 1% per year. $1,000 invested in CGMFX on January 1, 2000 would have grown to $5,196 by New Year's Day 2010. According to Morningstar, here are the annual returns of the CGM Focus fund during the "lost decade" –

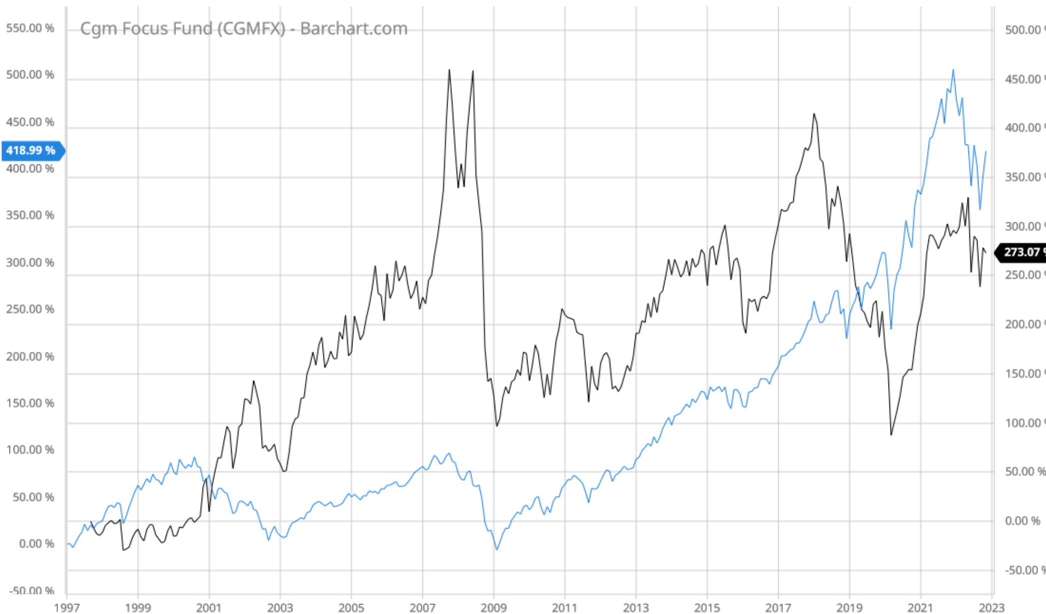
2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
+54%	+48%	-18%	+66%	+12%	+25%	+15%	+80%	-48%	10%

On six different occasions the fund's annual return changed by more than 50% from one year to the next. After rising 80% in 2007, $2.6 billion of new money flowed into the fund. Why invest in a boring index fund when you can invest with *"the best fund manager of our time"*? But you can't buy past performance. The fund fell 48% in 2008, underperforming the S&P 500 by 11%, and its 10% return in 2009 trailed the S&P 500 by 15%. This reversal of fortune snared many performance chasing investors who were hoping to earn past gains but only received future losses. Despite the fact that it was outperformed by 98% of its peers during 2008 and 2009, CGMFX was still the best-performing U.S. diversified stock mutual fund for the "lost decade", according to Morningstar.

However, a mutual fund's published annualized performance doesn't really tell us much about the returns that the fund's investors received. Few, if any, investors buy fund shares on January 1st and then sell on December 31st of a subsequent year. Top performing funds attract performance chasers who quickly flee if future performance disappoints. Instead of annualized data, we need the "dollar weighted" return of CGM Focus. Dollar weighting analyzes the movement of money into and out of a fund and computes the return that the average dollar (investor) in the fund received. Typically, investor returns are lower than a fund's published returns. According to Morningstar, this "investor gap" is caused by poorly timed purchases and sales of fund shares, which leave investors with lower returns than they would have earned if they had simply bought and held. Morningstar's dollar weighting calculations for CGM Focus reveal that while the fund's annualized average return from 2000 through 2009 was 18%, the average annualized return for CGMFX investors was a loss of 11%. This 29% investor gap was among the worst of any fund tracked by Morningstar for that decade.

What explains the fund's extremely volatile returns from one year to the next? It's simple. In an attempt to maximize return, Heebner shunned diversification. CGMFX had a high portfolio turnover and typically held between 20 and 25 stocks concentrated in just a few market sectors. One or two good picks could produce spectacular returns for the year. On the other hand, picking one or two big losers could produce dreadful losses.

Fast forward to 2022. For the 5 years ending November 1, 2022, CGMFX underperformed 75% of comparable funds. In a September 2022 regulatory filing with the SEC, Boston-based Capital Growth Management LP, the fund's investment adviser noted that it *"has determined to cease operations and liquidate the holdings in CGM Focus fund on or about November 30, 2022 at which time the Fund will cease to pursue its investment objective."* RIP CGMFX



This chart compares the cumulative performance of CGMFX (black line) to the S&P 500 (blue line) for the life of the fund. In 2019, the cumulative return of the fund fell below that of the S&P 500 and never recovered. Its total return was 273% vs. 419% for the S&P 500. Most people are uncomfortable with the volatility of the S&P 500. But the volatility of CGMFX made the S&P 500 look calm in comparison. Investors were quick to jump on board when the left side of the chart looked like the left side of the Eiffel Tower and quick to flee when the right side of the chart looked like the right side of the Eiffel Tower.

Despite his high-risk approach, Heebner's track record at times was impressive. But the question never addressed by the financial media was whether Heebner's performance was the result of skill or luck. Over the past few decades, the average fund manager has become more skilled, making it more difficult for anyone to consistently outperform the competition. This is called the paradox of skill. Consequently, luck becomes the most likely factor in outperformance. The effect is analogous to a roulette wheel in a casino. A lucky player may win on a small number of spins but over many spins the house's advantage is insurmountable. Like the roulette player, the active fund manager might be a winner in the short run but will likely lose in the long run. Thousands of money managers are attempting to outperform the market. Lady Luck will anoint a select few who, for a brief moment in time, will wear the crown of Investment Superstar, receive countless accolades in the financial media and appear on the cover of financial magazines. History reveals that all will eventually have to surrender their crown. CGMFX was a classic example of how a combination of luck and good timing can produce excellent results – but not on an ongoing basis.

It's hard to imagine how much time, energy, money, brainpower and effort is wasted each day by active investors attempting to beat the market, or to put it differently, to outperform dumb, cheap, effortless index funds. Millions of investors have learned the hard way that this is a futile task, leaving them with nothing but higher tax bills, wasted commission dollars and invisible missed opportunity costs. Index funds are hard to beat because they don't make mistakes and minimizing mistakes is more important to wealth creation than finding the best fund manager.

In the News

The financial media has too many "perma-bears" who relentlessly proclaim reasons why the world and everything we hold dear is about to end. They've been wrong time and time again, yet they keep preaching the same sermon. Do they really believe all their gloom and doom? Or have they discovered that spouting misery a lucrative profession that attracts a large audience of people eager to have their fears confirmed? Indoor work, no heavy lifting, just sitting at a keyboard in air-conditioned comfort, sipping a latte and thinking up new reasons why the economy, the stock market and the country are all going to Hell. I believe that most of them know that they're just making it all up, and I'm willing to bet that they don't live as if their prophesied miseries will come to pass any time soon.

A recent topic among the perma-bears concerns the imminent crash of the dollar and the end of its tenure as the world's reserve currency - the primary currency used for trade and financial transactions across the globe. After all, China, India and Russia are buying oil in non-dollar transactions!

Claims of the dollar's imminent demise are nothing new and ignore the reality of international finance. The dollar is the global currency of choice, half of the $2 trillion notes are in circulation outside the USA. In many countries, retail day-to-day usage of the dollar supersedes the local currency and about 40% of the world's non-US debt is denominated in dollars. A reserve currency must be stable, safe, a store of value, and a trusted medium of exchange. The dollar represents about 60% of global central bank reserves, down from 67% 20 years ago but still more than all other currencies combined, according to the International Monetary Fund. The euro is in second place with about 20%. Central banks need to know that their money is readily available when needed, particularly in times of stress. The issuing country must have a stable political system, a large economy, transparent, well-regulated, liquid financial markets, and high-quality sovereign debt. The euro area, Japan and the United Kingdom are the only other economies that have some of the qualities needed to support a reserve currency, but none have financial markets with the depth and liquidity to support international finance and trade. Many traders do not want to hold the currency of their trading partners. Thus, according to the Federal Reserve, almost 90% of international trade is invoiced in U.S. dollars or euros. Trade in the Chinese yuan accounted for less than 2% of global trade and 2.7% of global foreign currency reserves in 2022. We are a long way away from the day when central bankers will be willing to place their country's reserves in a currency that is manipulated by the Chinese Communist Party.

The DXY Currency Index is a measure of the value of the U.S. dollar against six currencies - the Euro, Japanese Yen, British Pound, Canadian Dollar, Swedish Krona, and the Swiss Franc.

As can be seen in this chart, although the dollar's exchange rate has been volatile over the past 25 years, its closing price on April 28 2023 was 2.0% higher than where it stood on April 30, 1998.

The dollar's surge after Russia invaded Ukraine revealed that it remains the safe haven of choice for foreign investors during geopolitical turmoil.

In your portfolio, international stock funds act as a hedge against a falling dollar. When the dollar's value sags versus foreign currencies, the performance of international funds gets a boost when share prices are converted into dollars. I don't recommend foreign bonds. Bonds are in your portfolio for stability and diversification, and you don't want to add currency volatility to the safe portion of your portfolio. International stocks don't provide the same diversification benefit as domestic bonds, but they provide some benefit, with returns that have been better than bonds.

An article in *The Wall Street Journal* last month noted – *"Stock pickers missed out on the first-quarter rally…Only one in three actively managed large-cap mutual funds beat their benchmarks in the first three months of the year, the worst performance since the three-month period ended December 2020, according to data from Bank of America Global Research."*

Supposedly, Fidelity released a study in 2013 detailing the performance of their retirement accounts from 2003 to 2013. Purportedly, investors with the second-best returns for the decade were those who forgot that they had the account and made no trades. The clients that did the best were those who were dead, and thus couldn't make trades. How many dead clients could there be at Fidelity, how did Fidelity know they were dead and once they found out, how could Fidelity keep the money? I can't find this study anywhere on the web, so I assume that it is apocryphal. However, the general notion is sound. In a well-known study, University of California professors Brad Barber and Terrance Odean analyzed 66,000 household accounts at a discount brokerage firm over a five-year period. During this period of study, the stock market rose 18%, the average trader earned 16% and the most active traders earned 11%. This, and other studies since then, have shown that trading frequency and performance are inversely related.

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