

Great-West Capital Management, LLC (GWCM) Research Note

Rising to the top hitting singles and doubles

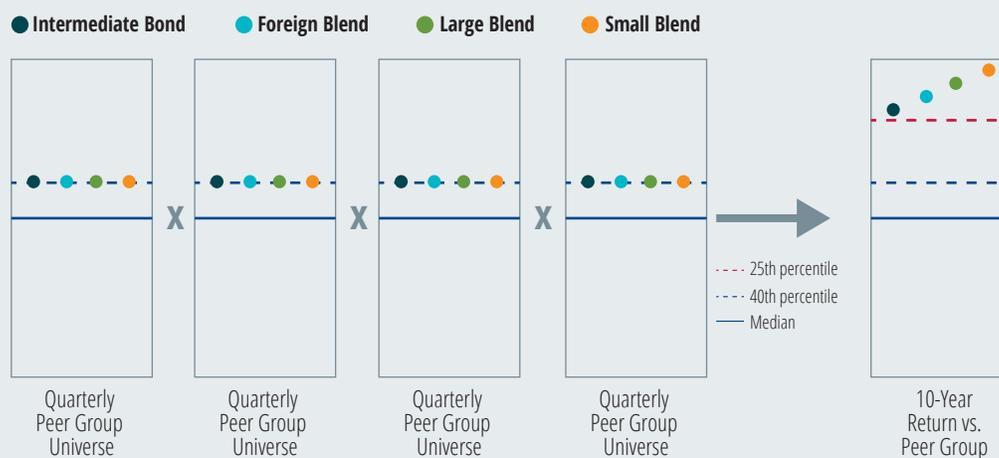
One of the goals of effective investment manager selection is to identify managers whom GWCM expects will outperform over the long run. This is no easy task, as we are effectively utilizing historical characteristics in an attempt to predict the future (or at least tilt the future in our favor). Effective manager selection combines both qualitative and quantitative assessments of a manager's skill in selecting investments. This is done with the expectation that the great deal of up-front analysis will result in a manager who is able to generate compelling future returns for the investment portfolio.

But what type of manager is capable of generating long-term performance results? We believe there are various types of managers and each of these manager types generates performance in different ways. One type of manager generates returns through the successful implementation of a higher risk, higher reward approach. These managers tend to hold more concentrated portfolios and, if successful, can easily put up compelling returns over the long run. However, this investment style may exhibit a volatile return pattern from year to year in the pursuit of various home runs. As a result, this approach may send investors running for cover, potentially to the long-term detriment of their retirement account balances.

A second type of investment manager is one who tends to outperform by a small amount each year, but on a consistent basis. In baseball terms, one could think of this type of manager as hitting singles and doubles as opposed to the home run sought by the manager described earlier. **The idea is that, by outperforming by only a small amount each year, a manager will float to the top over the long run, avoiding the lumpy performance that tends to come with more concentrated, high-conviction managers.**

To demonstrate this point, we calculated a simulated return stream to show that a fund manager who consistently generates slightly above-average returns can rise to the top over the long run. This quantitative evaluation used the 40th percentile return on a quarterly basis for the last 10 years for four Morningstar® categories¹.

We then linked the quarterly returns to calculate a 10-year simulated performance number and compared it to both the Morningstar peer group and a benchmark to see how well our simulated, mediocre manager performed.



¹ These categories tend to be large, diversified fund categories with broad representation by many different investment firms and styles of investing.

The results were compelling—in all four cases, our simulated managers were in the top quartile of their respective peer groups and significantly outperformed their benchmarks over the 10-year period. In the large-cap and small-cap scenarios, our simulated quarterly 40th percentile return stream was in the top 14% and 9% of their Morningstar categories, respectively, over the 10-year period. The intermediate-term bond track record was in the top 24%, and the foreign manager achieved top 20% relative to their respective Morningstar categories.

Simulated Performance Peer Group Ranking and Benchmark Comparison

As of 6/30/2015

CATEGORY	40TH PERCENTILE RETURN	PERCENTILE RANK	10 YR BENCHMARK RETURN	BENCHMARK
Small Blend	9.64%	9th	8.40%	Russell 2000®
Large Blend	8.36%	14th	7.89%	S&P 500®
Foreign Bond	6.40%	20th	5.12%	MSCI EAFE
Intermediate Bond	5.02%	24th	4.44%	Barclays Capital U.S. Aggregate Bond

Source: Morningstar® DirectSM; GWCM Analysis. The table reflects the quarterly 40th percentile net of expense return of each peer group over a ten year period, including funds that did not survive the full ten year period. The benchmark returns are the 10- year annualized returns of the Russell 2000, S&P 500, MSCI EAFE, and U.S. Barclays Capital Aggregate Bond indices as of June 30, 2015. A benchmark index is not actively managed, does not have a defined investment objective, and does not incur fees or expenses. Therefore, performance of a fund will generally be less than its benchmark index. You cannot invest directly in a benchmark index. *Past performance is not a guarantee of and may not be indicative of future results.*

How does this translate to the methodology of selecting fund managers? We often look to the investment manager philosophy and process and ask the question: is this consistently repeatable? While it would be very difficult to duplicate 40th percentile results, quarter after quarter, in the real world, the results of this analysis justified our assumptions. Does a fund manager need to take large bets to achieve best-in-class performance? Our conclusion is no, and that approach may hurt long-term performance if the bet proves wrong. While we would not be disappointed with a home run or two, a consistent batting average with many singles and doubles may produce more favorable results that typically align with what retirement plans are looking for.

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