

Revisiting "In Search of Excellence: A Portfolio Management Perspective"

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In their critically acclaimed 1982 business management bestseller, *In Search of Excellence: Lessons from America's Best-Run Corporations*, authors Thomas Peters and Robert Waterman, Jr., listed six financial indicators of "excellent" management, which readers in any era will recognize as pertinent metrics of financial performance. The measures Peters and Waterman cited were

- five-year growth of total assets;
- five-year growth of shareholder equity;
- five-year average return on sales;
- five-year average return on average total capital;
- five-year average return on average total equity;
- five-year average year-end price to book.¹

We revisit Barry Bannister's March/April 1990 *Financial Analysts Journal* (FAJ) article titled "In Search of Excellence: A Portfolio Perspective," which examined portfolio returns for stocks in the historical S&P 500 Index (i.e., as the index membership existed at the end of each calendar year) over the 12-year period 1977 to 1989, comparing high versus low performers using the six Waterman/Peters screening criteria. With current access to more than three times the financial data via FactSet and the S&P Capital IQ histor-

ical database, we were able to replicate the study of portfolio total returns using the same screening criteria over a longer period of 41 years, from 1972 to 2013.

The basis for the original 1990 Bannister study was the May/June 1987 FAJ article by Michelle Clayman entitled, "In Search of Excellence: The Investor's Viewpoint." Clayman examined the period 1980 to 1985, applying the six Waterman/Peters financial variables for companies that existed as of year-end 1980. She explored the phenomenon known as "reversion to the mean" by which key financial ratios of companies tend, over time, to revert to the mean for the market as a whole.

The thesis Clayman described is easily defended. High returns are symptomatic of strong cycles for a particular industry and eventually invite new entrants that drive down profitability, while poor returns cause the exit of competitors, leaving a more profitable industry for the survivors. On a company level, years of under-performance in financial metrics often lead to new management, a turn-around plan, or take-over by a competitor or financial buyer. The securities analyst is caught in the middle of this paradox and must weigh whether "excellence" in terms of financial returns and ratios is both discounted in the stock price and a source of potential downside risk for portfolio managers that is

attributable to mean-reversion tendencies for the high flyers.

THE SCREEN

In our new study and identical to the 1990 article procedure, the S&P 500 as it existed each calendar year-end (CYE) was screened for the six Waterman/Peters financial variables for the trailing five fiscal years (FY). For example, the CYE 1971 S&P 500 members were screened for the years FY1967 to FY1971. A list of stocks was compiled for companies in the top one-third (termed the "Excellent" portfolio) and bottom one-third (termed the "Un-Excellent" portfolio) in all six screening criteria, a clean sweep of strong and weak past performers on a financial basis.

With the portfolios thus constructed, we measured the equal-weighted total return (price plus dividends²) for each portfolio over the subsequent three-year period, starting June 30 of the following year. Using the aforementioned screening example derived from the CYE 1971 S&P 500, we measured total return performance

of stocks in the equal-weight Excellent and Un-Excellent portfolios for the period June 30, 1972, to June 30, 1975.

We chose June 30 of the following year for portfolio construction in order to allow investors time to receive and analyze financial data.³ This process was repeated for each year, 1973 (screening FY1968 to FY1972) to 2013 (screening FY2008 to FY2012). Additionally, our portfolios excluded transaction costs, rolled merger and acquisition last trade price proceeds into 90-day U.S. T-Bills, and marked bankruptcies to \$0 in the year in which the filing occurred regardless of recovery.

THE RESULT

We found that \$1,000 invested at the end of every June beginning 1972 (a cumulative outlay of \$41,000) appreciated to \$1,615,054 as of June 2013 rolled forward in the Un-Excellent portfolios, compared with \$502,124 in the Excellent portfolios, \$637,048 in the S&P 500, and \$167,504 in gold bullion, shown in Exhibit 1.

EXHIBIT 1

\$1,000 Invested Annually, Various Cumulative Portfolio Values (June 30, 1972, to June 30, 2013)

Total Accumulated Capital: From investing \$1,000 annually into various asset classes June 30, 1972 to June 30, 2013

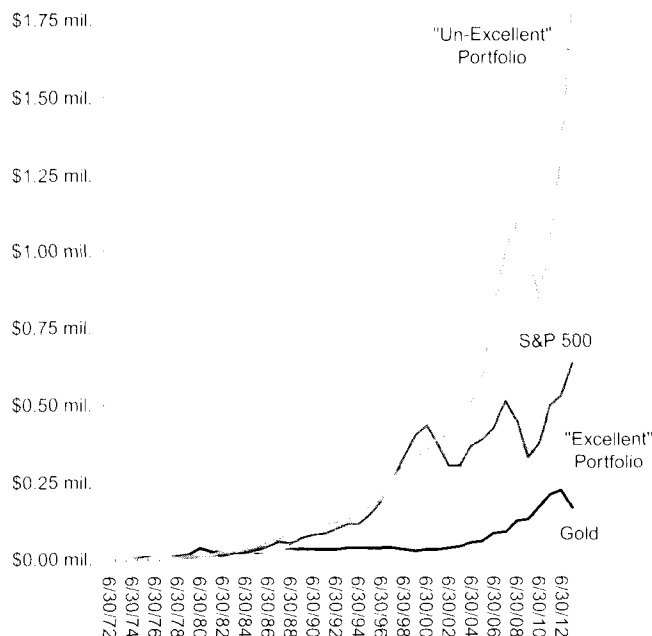
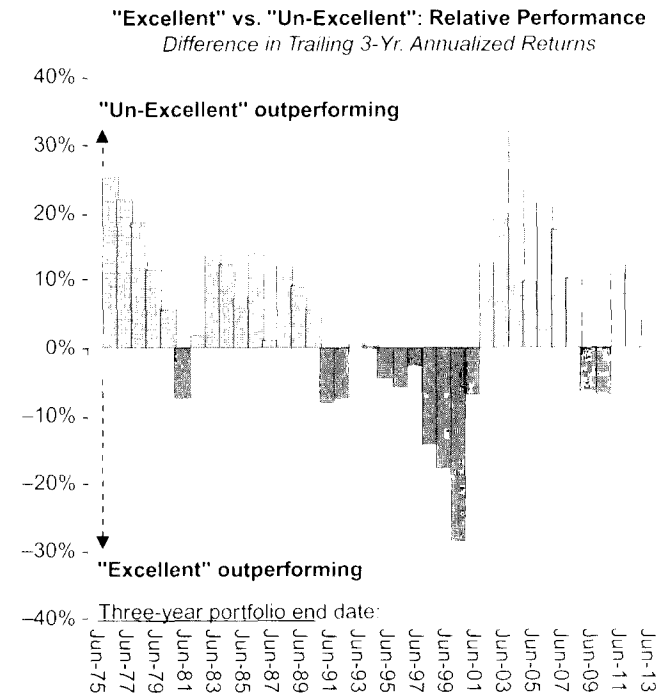


EXHIBIT 2

"Un-Excellent" Stock Portfolio Performance Minus "Excellent" Counterparts, 1970 to 2013, Global Economic Difficulty Shaded



Investors in excellent quality stocks often cite the defensive characteristics of the issues, but as shown in Exhibit 2, Excellent portfolio companies with strong financial track records only outperformed the Un-Excellent portfolios in 11 of 22 (50%) of the periods that featured "global economic difficulty," which we defined as years in which global real GDP growth was less than the 1970–2012 average of ~3.65% per the International Monetary Fund World Economic Outlook (WEO) database. By comparison, our Un-Excellent portfolios outperformed their Excellent counterparts in 15 of the 17 (88%) periods that did not feature global economic weakness.

As was the case in the 1990 study, conducted with a largely similar methodology,⁴ we found that in the majority (67%) of the past 39 years the Un-Excellent portfolios significantly outperformed the Excellent portfolios (see Exhibit 3). They also exceeded the performance of the S&P 500 (total return) and gold over the cumulative duration of our study. Even after adjusting for risk (intra-portfolio standard deviation⁵), the Un-Excellent portfolios still outperformed the

Excellent portfolios in 25 of 39 years (64% of the time); see Exhibit 4.

Further historical Un-Excellent and Excellent portfolio detail is provided in Exhibit 5. Over the test period 1972 to 2013, there were an average 31 stocks in both the Excellent and Un-Excellent portfolios, with many companies falling into the same group for several years in a row. The largest number of companies appearing in any one portfolio from 1972 to 2013 was 54, the smallest 11. Instances of bankruptcy filing were more prevalent in the Un-Excellent portfolios,⁶ as would be expected, with nine instances over the 1972 to 2013 period among the Un-Excellent portfolios versus only one bankruptcy in the Excellent portfolios in the period.

With the ultimate goal of providing timely recommendations for portfolio strategy, we closely monitor the performance of ongoing portfolios formed June 30 of 2011 and 2012 to be held until June 30, 2014/15 (now 2/3 and 1/3 complete, respectively). Through June 30, 2013 (the date of this writing), the equal-weighted return of the former (two-thirds complete) CYE 2010

EXHIBIT 3

Unadjusted Three-Year Portfolio Returns: "Un-Excellent" vs. "Excellent" Portfolios, 1972–2013

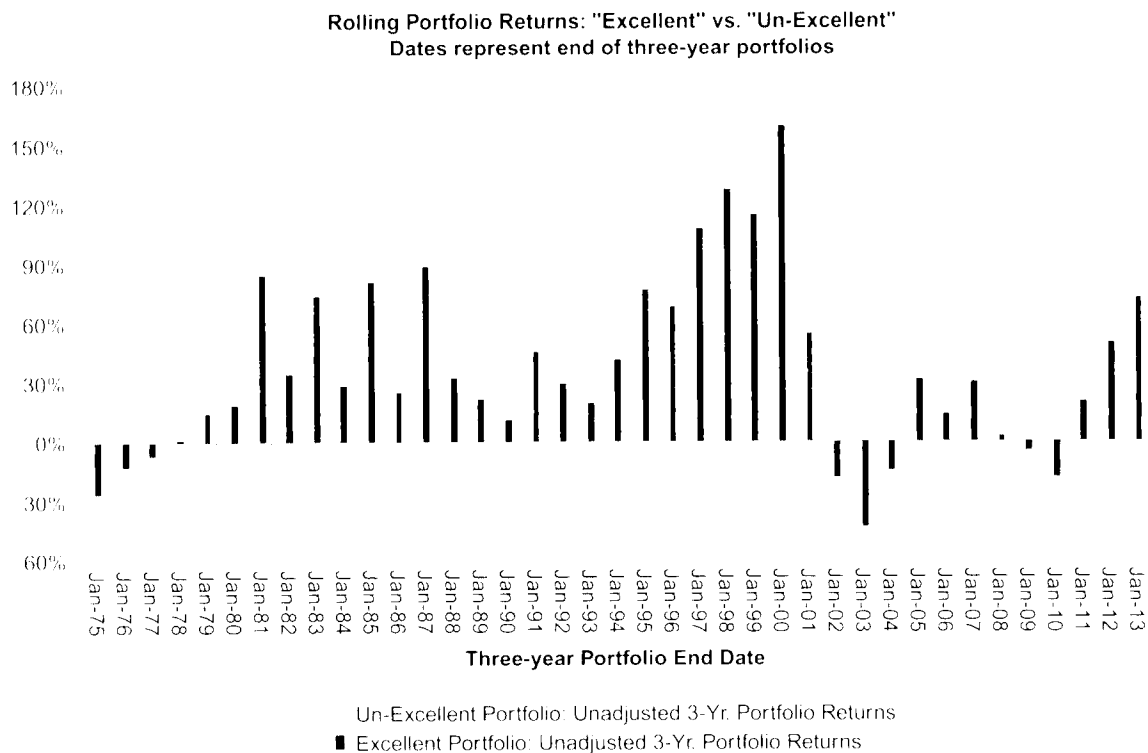
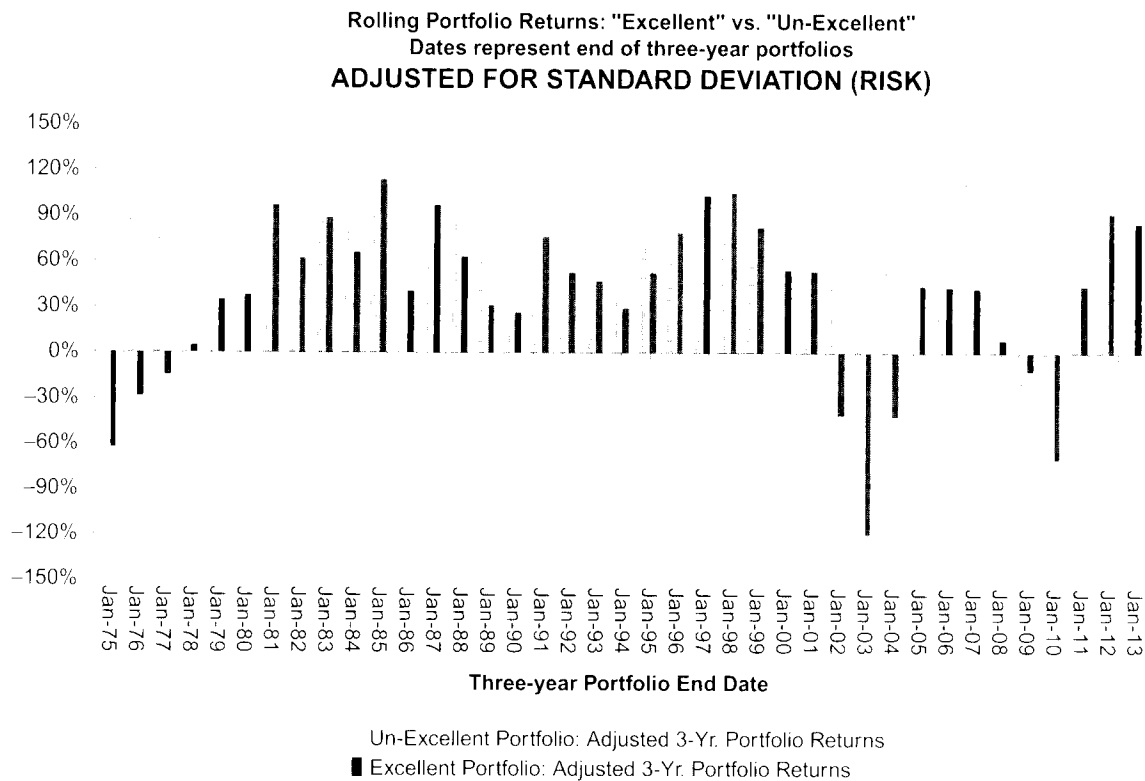


EXHIBIT 4

Risk-Adjusted Portfolio Returns, 1972–2013



Note: Shaded areas are years in which global real GDP growth (average for portfolio holding-period) was less than the 1970–2012 average of ~3.65% per the International Monetary Fund World Economic Outlook (WEO) database.

Un-Excellent portfolio that commenced June 30, 2011, was 42.9%, or 21.3% above the S&P 500 (which returned 21.6%), compared with a (–3.3%) relative return for the Excellent portfolio. The standard deviation of excess returns for the CYE 2010 Un-Excellent portfolio has been 48% versus 50% for the Excellent portfolio. Therefore, on a risk-adjusted basis, Un-Excellence still beats Excellence for investment returns 6/11–6/13.

Examining the analogous data for the latter, nascent portfolio formed June 30, 2012 (i.e., based on a screen of the CYE 2011 S&P 500 based on the financial results for the period FY07 to FY11), the Un-Excellent portfolio return was 40.4%, outperforming the benchmark S&P 500 index return of 17.9% over the one-year period, as well as the Excellent portfolio which has returned 21.2%. Adjusting for standard deviation of intra-portfolio returns (28.9% and 47.7% for the CYE 2011 Un-Excellent and Excellent, respectively), the

adjusted return of our Un-Excellent portfolio (up 78%) far exceeds that of our Excellent portfolio (up 6.8%) from June 30, 2012, to June 30, 2013.

In Exhibit 6, we provide the newly-formed Excellent and Un-Excellent portfolios created June 30, 2013 (the time of this writing). Notably 20 of 33 stocks (61%) of the Un-Excellent portfolio constituents are from lower price-to-equity ratio (P/E) or “Value” sectors, namely Financials, Energy, Basic Materials, Industrials, and Technology. Interestingly, 8 of 33 (24%) of the new Un-Excellent portfolio names are Financials, compared with no Financials in the Excellent portfolio.

Within the Excellent company portfolio, defensive Consumer Non-Cyclical composes 7 of the 20 stocks in the June 30, 2013 portfolio (35%), versus just 2 of 33 (6%) within the Un-Excellent portfolio. In addition, large-capitalization “Old Tech” composes 3 of 20 (15%) of the Excellent company portfolio, perhaps testament

EXHIBIT 5

"Un-Excellent" and "Excellent" Company Portfolio Performance Details, 1972–2013

Start Date	End Date	"Un-Excellent" Portfolios: 3-Year				"Excellent" Portfolios: 3-Year			
		# Stocks	Unadj.	Std. Dev.	Adj. Ret.	# Stocks	Unadj.	Std. Dev.	Adj. Ret.
6/30/1972	6/30/1975	22	-4.2%	40.1%	-10.3%	28	-25.5%	39.9%	-63.9%
6/30/1973	6/30/1976	32	75.1%	80.0%	93.8%	32	-12.7%	43.2%	-29.4%
6/30/1974	6/30/1977	40	70.9%	69.4%	102.2%	30	-6.6%	43.7%	-15.2%
6/30/1975	6/30/1978	41	68.0%	83.9%	81.1%	31	1.6%	32.5%	4.8%
6/30/1976	6/30/1979	40	56.7%	98.7%	57.5%	37	15.4%	45.1%	34.2%
6/30/1977	6/30/1980	45	38.4%	91.4%	42.0%	31	19.3%	52.0%	37.2%
6/30/1978	6/30/1981	54	53.7%	78.3%	68.6%	38	88.6%	92.5%	95.8%
6/30/1979	6/30/1982	54	40.7%	66.0%	61.7%	40	35.2%	56.9%	61.9%
6/30/1980	6/30/1983	51	140.5%	155.0%	90.7%	37	74.4%	84.4%	88.2%
6/30/1981	6/30/1984	49	77.1%	77.8%	99.1%	33	29.3%	45.0%	65.1%
6/30/1982	6/30/1985	51	114.3%	104.6%	109.4%	46	82.0%	72.5%	113.2%
6/30/1983	6/30/1986	50	80.0%	110.2%	72.6%	40	25.7%	63.7%	40.4%
6/30/1984	6/30/1987	48	93.7%	103.7%	90.4%	34	89.5%	92.4%	96.9%
6/30/1985	6/30/1988	41	80.5%	90.4%	89.1%	38	32.9%	52.8%	62.3%
6/30/1986	6/30/1989	45	53.9%	65.7%	82.1%	38	22.0%	72.3%	30.4%
6/30/1987	6/30/1990	40	29.1%	59.9%	48.6%	38	11.4%	43.7%	26.2%
6/30/1988	6/30/1991	44	18.0%	60.3%	29.8%	39	46.5%	61.3%	75.9%
6/30/1989	6/30/1992	38	4.8%	49.0%	9.8%	28	30.3%	58.0%	52.3%
6/30/1990	6/30/1993	40	22.4%	60.1%	37.3%	33	20.1%	43.4%	46.4%
6/30/1991	6/30/1994	22	46.8%	88.6%	52.8%	37	41.7%	142.6%	29.3%
6/30/1992	6/30/1995	27	61.4%	78.3%	78.4%	42	78.4%	147.2%	53.3%
6/30/1993	6/30/1996	23	44.8%	66.5%	67.3%	41	68.0%	86.8%	78.3%
6/30/1994	6/30/1997	23	96.3%	104.1%	92.6%	35	106.3%	105.1%	101.2%
6/30/1995	6/30/1998	27	61.7%	79.1%	77.9%	37	128.7%	122.3%	105.2%
6/30/1996	6/30/1999	17	38.3%	64.5%	59.4%	37	115.9%	140.3%	82.6%
6/30/1997	6/30/2000	12	29.9%	59.6%	50.1%	35	160.3%	296.8%	54.0%
6/30/1998	6/30/2001	12	29.1%	45.1%	64.4%	30	55.3%	103.3%	53.5%
6/30/1999	6/30/2002	11	17.7%	41.6%	42.6%	26	-18.3%	43.5%	-42.1%
6/30/2000	6/30/2003	11	6.1%	66.5%	9.2%	25	-42.7%	35.3%	-121.0%
6/30/2001	6/30/2004	11	57.1%	53.2%	107.3%	33	-14.4%	34.0%	-42.4%
6/30/2002	6/30/2005	17	68.7%	65.9%	104.3%	22	32.0%	72.6%	44.1%
6/30/2003	6/30/2006	21	121.1%	96.6%	125.4%	20	14.7%	34.3%	42.9%
6/30/2004	6/30/2007	22	102.6%	71.1%	144.3%	19	30.7%	73.0%	42.1%
6/30/2005	6/30/2008	20	35.6%	88.0%	40.5%	20	2.7%	34.5%	7.9%
6/30/2006	6/30/2009	21	-22.2%	42.2%	-52.6%	14	-5.1%	39.2%	-12.9%
6/30/2007	6/30/2010	19	-35.0%	33.6%	-104.1%	18	-18.4%	26.0%	-70.9%
6/30/2008	6/30/2011	16	62.5%	122.2%	51.1%	15	20.6%	47.4%	43.6%
6/30/2009	6/30/2012	22	102.9%	110.2%	93.4%	19	50.3%	54.6%	92.2%
6/30/2010	6/30/2013	27	92.8%	79.0%	117.5%	23	72.9%	85.4%	85.4%

EXHIBIT 6

Hypothetical Portfolios as of June 30, 2013
(Based on a Screen of FY2008–FY2012 Data)

Symbol	Company Name	5-Yr. Trailing Rel. Return
Un-Excellent Portfolio (2013–16)		
AA	Alcoa Inc.	(-100.7%)
ALL	Allstate Corp.	(-9.8%)
AEE	Ameren Corp.	(-24.3%)
AIG	American International Group Inc.	(-114.4%)
BSX	Boston Scientific Corp.	(-50.1%)
CBS	CBS Corp (CIB)	135.4%
CSC	Computer Sciences Corp.	(-26.7%)
COP	ConocoPhillips	(-25.3%)
DHI	D.R. Horton Inc.	78.6%
DVN	Devon Energy Corp.	(-79.4%)
FHN	First Horizon National Corp.	58.4%
HBAN	Huntington Bancshares Inc.	22.9%
TEG	Integrus Energy Group Inc.	16.4%
JCP	J.C. Penney Co. Inc.	(-69.6%)
LM	Legg Mason Inc.	(-49.9%)
LEN	Lennar Corp. CIA	174.0%
MWV	Mead Westvaco Corp.	57.9%
MU	Micron Technology Inc.	113.3%
MOLX	Molex Inc.	9.6%
NFX	Newfield Exploration Co.	(-88.9%)
NYX	NYSE Euronext	(-31.9%)
PHM	Pulte Group Inc.	72.3%
RF	Regions Financial Corp.	(-33.6%)
SWY	Safeway Inc.	(-33.5%)
LUV	Southwest Airlines Co.	(-25.5%)
S	Sprint Nextel Corp.	(-51.6%)
TEL	TE Connectivity Ltd.	11.6%
TWX	Time Warner Inc.	78.6%
X	United States Steel Corp.	(-115.1%)
VLO	Valero Energy Corp.	(-26.5%)
VMC	Vulcan Materials Co.	(-37.4%)
WPO	Washington Post Co. CIB	(-34.4%)
XL	XL Group PLC	33.4%
Excellent Portfolio (2013–16)		
ALXN	Alexion Pharmaceuticals Inc.	383.4%
ALTR	Altera Corp.	40.5%
APH	Amphenol Corp. CIA	50.0%
AAPL	Apple Inc.	117.9%
CTSH	Cognizant Technology Solutions Corp.	67.2%
EW	Edwards Lifesciences Corp.	91.1%
FLIR	FLIR Systems Inc.	(-57.3%)
GILD	Gilead Sciences Inc.	68.2%
ISRG	Intuitive Surgical Inc.	62.4%
JOY	Joy Global Inc.	(-56.9%)
MA	MasterCard Inc. CIA	92.4%
MSFT	Microsoft Corp.	12.0%
ORCL	Oracle Corp.	25.5%
PCLN	priceline.com Inc.	590.5%
SLB	Schlumberger Ltd.	(-54.3%)
SNI	Scripps Networks Interactive Inc. CIA	53.6%
TDC	Teradata Corp.	91.6%
VAR	Varian Medical Systems Inc.	4.6%
WAT	Waters Corp.	29.6%
WU	Western Union Co.	(-50.9%)

Note: S&P 500 total return 06/30/2008–Present: 42.2%

to a shift to smaller growth stocks within Technology going forward. With respect to portfolio allocation, we believe this is supportive of a *reversion to the mean* hypothesis that favors Value over expensive Consumer or Defensive beneficiaries of the recent uncertainty.

In the future we anticipate a continuation of Un-Excellent outperformance, especially if rebalancing of global GDP growth continues. We remain cognizant of challenges in the global economy (China slowdown, excessive Eurozone austerity, currency effects with respect to country-level deflation/inflation) and note IMF recently trimmed 2013 estimates for global GDP from 3.3% to 3.1%, and 2014 estimates from 4.0% to 3.8%.

CONCLUSION

We find that what constitutes “excellence” for managers is most often not the case for investors. We believe the exceptional long-term total return and superior periodic returns available from the Un-Excellent portfolios are supportive of a disciplined and patient “Value” investment process. While financial “excellence” as defined by Waterman and Peters is a laudable management achievement, we find that it tends to produce a high-priced stock with potential for downward mean reversion. It is our view that a more rewarding investment strategy over time is the purchase of a portfolio of equities in financially solvent companies whose abysmal growth record of late has washed the last glimmer of hope out of the stock price. As the “Un-Excellent” companies revert to the mean, their stock performance is anything but average.

ENDNOTES

¹Although price/book is not explicitly in management’s operating purview, leaving that valuation measure out of the screening variables in a back-test for the period 1993 to 2012 (20 portfolios) did not meaningfully change the results. We found 60% (12/20 total) of Un-Excellent portfolios outperformed the Excellent portfolios, un-adjusted for risk. Excluding price/book did, however, increase the dispersion of returns in the Un-Excellent portfolios, reducing the frequency of risk-adjusted betas versus the Excellent company stock portfolio to 45% (9/20 total).

²For stocks without stock price/dividend data available in FactSet, we used the Mergent Online database, calculating the average of annual high and low prices for share data. Dividend payment dates were often not specified, so we assigned

a 50% probability that they were received in years a company was held in a portfolio from or until June 30 (halfway through the year, receiving two of four quarterly dividends, one of two semi-annual dividends, or having a ~50% probability of receiving a one-time special dividend payout). We then used probability-weighted total dividends received to calculate total returns.

³Based on a study we conducted for the years 1993 to 2011, 100% of Excellent/Un-Excellent firms with fiscal years ending in February reported annual results by June 30, as did 92% with a FYE in March. Conversely, 87% of firms with FY's ending in April failed to make the June 30 cut-off. Based on these findings, we assumed companies with fiscal dates in April or later would have been rolled into subsequent year portfolios, having missed the June 30 portfolio construction date. Pre-1993 filing dates were unavailable for the earlier years.

⁴There were some differences between the March/April 1990 FAJ Bannister study and this one, as databases have improved with time. For the period 1977-89 (the period in the 1990s study) vis-à-vis the current study period, the average three-year portfolios return of the 10 Excellent/Un-Excellent portfolios examined in 1990 was 51.3%/76.7%, while for the current study in the same 1977-89 period we found the average was 49.9%/77.3%, a modest difference. A principal difference affecting returns between the two studies was that for any stock subject to corporate action (take-over, M&A) the proceeds in the 1990 study earned no return after the acquisition date, and dividends for the stock involved in corporate action were excluded for the entire period the stock

was held. In the new study corporate action proceeds were invested in 90-day U.S. T-bills and the pre-corporate action return included applicable dividends.

⁵Three-year portfolio return divided by standard deviation of individual stock three-year equity returns.

⁶Bankruptcy instances in the portfolios occurred as follows: GAC Corp. ('76), Food Fair, Inc. ('78), White Motor Corp. ('80), Evans Products Co. ('85), Allis-Chalmers Corp. ('87), Lone Star Industries ('90), U.S. Home Corp. ('91), Bethlehem Steel Corp. ('01), Circuit City Stores, Inc. ('08), and The Federal Home Loan Mortgage Corporation ('08). Only Storage Technology ('84) entered bankruptcy and was a member of an Excellent portfolio; all others were members of Un-Excellent portfolios.

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Disclosure

Source materials used in constructing all charts and tables were provided by S&P Capital IQ, FactSet, Bloomberg, and are Stifel format.

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**DECOMPOSING HEDGE FUND RETURNS:
*What Hedge Funds Got Right for the
Past 20 Years*** 9

HAIM A. MOZES

This article identifies three drivers of hedge funds' strong risk-adjusted returns over the past 20 year. First, hedge funds had a number of factor exposures which generated positive returns but did not increase overall portfolio risk, due to how these factors correlated with other exposures. Second, hedge funds timed several of their risk exposures very sensibly. Third, hedge funds used their superior funding ability to exploit opportunities that offered positive expected returns but below that of the risk-free rate. Most investors ignore these opportunities due to the high opportunity cost, but hedge fund managers, who have superior ability to fund cheaply (e.g., Fung and Hsieh [2011]), do not.

**REVISITING "IN SEARCH
OF EXCELLENCE: A Portfolio
Management Perspective"** 21

BARRY B. BANNISTER AND JESSE B. CANTOR

Using the six financial indicators of "excellent" management described by Thomas Peters & Robert Waterman, Jr. in their 1982 management bestseller 'In Search of Excellence: Lessons from America's Best-Run Corporations' the authors screened the reconstructed S&P 500 as it existed at year-end 1971 to 2013, forming two portfolios of stocks June 30 of the following year. One portfolio consisted of stocks in the top one-third of the S&P 500 in all six criteria for the trailing five fiscal years (termed the "Excellent" portfolio) and the other the bottom one-third of all six categories (the "Un-Excellent" portfolio). They found that \$1,000 invested at the end of every June beginning 1972 (a total outlay of \$41,000) would have appreciated to \$1,615,054 as of June 2013 rolled forward in the Un-Excellent portfolios, compared with \$502,124 in the Excellent portfolios and \$637,048 invested in the S&P 500.

**THE LIMITS OF EXPANDING
BREADTH: *The Trade-Offs between
Diversification and Forecasting
Ability*** 28

RALPH GOLDSTICKER

One crucial element in portfolio construction is obtaining maximum benefit from diversification. The objective of holding multiple positions in a portfolio is to reduce the risks from unintended bets, and to diversify the risks from attractive positions, while still letting the expected returns flow through to the bottom line. This relationship is described and quantified by the Fundamental Law of Active Management. It relates an active investment strategy's information ratio (ratio of expected active return to expected active risk) to manager skill and to portfolio breadth. This commentary explores the Law and its underlying assumptions, and examines how the implications of the Law can be used or misused. In order to understand the Law, we first discuss why the information ratio (IR) is the proper metric to use to evaluate unconstrained active strategies. Next we explore the Law, its assumptions, inputs, and implications. Most importantly, we examine the potential impact and limitations from expanding the number of positions in a portfolio on its IR. The objective of this article is to explore the trade-offs from expanding the number of positions in a portfolio (increasing the number of models, factors, and/or securities) on portfolios' expected risks, expected returns and IRs.

**IMPACTS OF INSTITUTIONS ON VENTURE
CAPITAL INVESTMENT ACTIVITIES:
*Evidence from China, India, Japan,
and Hong Kong*** 39

ANSON WONG LAI KUEN

The study is to investigate the importance of institutional forces to shape the venture capitalists' (VC) investment activities of VC firms in China, India, Japan and Hong Kong and