Structuring for Outperformance

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Abstract

- In my experience, about 20% of asset managers achieve returns which meaningfully outperform[1] both the relevant benchmarks and passive indexes over the long term.
- There are a few characteristics which I believe to be instrumental in achieving returns among the top quintile. We have taken each into account in structuring VELA.
- Fundamentally, outperformance requires a portfolio which differs substantially from the index. Thus, active managers like VELA are likely to produce short term results different than passive alternatives, which are designed to mirror a given index.
- A valid investment approach is also necessary, and some approaches that are not time-tested may lack efficacy over the long term. VELA's valuation-centric philosophy was pioneered by Benjamin Graham nearly 100 years ago, and taught to Warren Buffett, who has refined and popularized this philosophy for more than 60 years.
- Most importantly, outperformance requires an active manager to align their business interest with the clients' return objectives. Firm size, fees charged, and employee accounts are typically sources of mis-alignment. To best align our interests with those of our clients, each VELA colleague commits to investing solely in VELA strategies for each asset class in which we participate.

Introduction

In a recent reading of Andy Kessler's Wall Street Journal Column, "Inside View"[2], I was reminded of a somewhat forgotten 'rule of thumb' known as Sturgeon's Law. Theodore Sturgeon (1918-85) was a science-fiction author frustrated by a prevailing thought of his time-- that works of science fiction are universally bad. His defense of his chosen field, argued in a New York University lecture hall, can be boiled down to the argument that actually, '90% of *everything* is crap'[3].

As Kessler (and venture capitalist Marc Andreessen, his interview subject) note, this idea, referred to as Sturgeon's law, can be nearly universally applied. It includes movies, tv shows, scientific studies, politicians, opinions, and yes, *stocks.* Andreesen related the concept to his own field with the suggestion that only ten percent of Venture Capital funds can consistently return outsized performance to investors. This number seems particularly applicable to private markets, which suffer from greater information asymmetry than public counterparts.

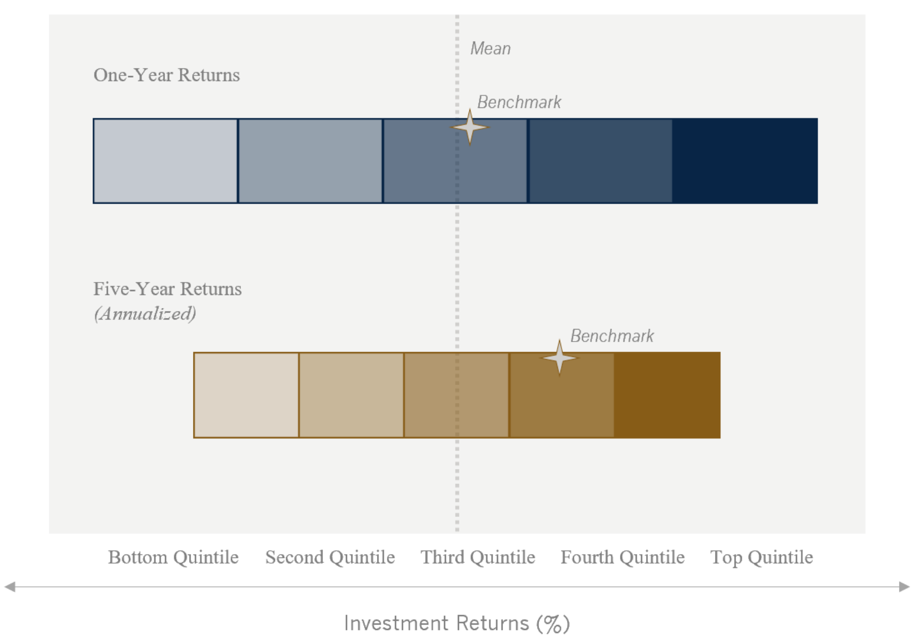
A slightly more studied take, Pareto's Law, credited to economist Vilfredo Pareto (1848-1923), gives a rosier outlook: for any given industry, 80% of results are driven by 20% of participants. In line with Pareto's Law, my experience suggests that only 20% of asset managers are able to achieve returns which meaningfully outperform the benchmark and passive indexes over the long term.

Illustrated in Graph 1 is the distribution of investment returns we'd expect to see over both a one-year and five-year period (which we consider to be the beginning of statistical significance). Over a single year, we'd expect to see substantial dispersion in returns due to short term market fluctuations, and benchmark performance which is close to the average of all managers.

Over longer-term periods, we expect more consolidation in returns, but also a meaningful difference in the relative performance of managers vs. the benchmark. As the effects of fees and operating costs, inefficient investment approaches, and misalignment of interests are compounded over time, it becomes significantly more difficult for managers to outperform. This brings us back to Pareto's 20%.

Over my career, I've found that there are a few notable firm and strategy characteristics which I believe to be instrumental in positioning funds to achieve returns among the top quintile relative to peers. We've taken each into consideration in structuring our strategies at VELA.

Graph 1. Distribution of Investment Returns



Source: VELA Investment Management, LLC. Graph shown is hypothetical for illustrative purposes only.

Investing in US Equity Markets

There are thousands of organizations in the US that invest directly or indirectly in publicly traded stocks. While not all will be capable of generating optimal returns, this high degree of competition has a net positive effect on the economy by promoting lower costs and efficient allocation of capital.

Among market participants are a few types of **direct investors**, such as *Asset Managers,* including large firms like Blackrock and Vanguard, and small firms like VELA; large public *Pension Funds* such as Ohio PERS, and large *Endowment Funds* at universities like Harvard. Each of these groups construct and manage portfolios comprised of individual equity securities. Where the latter two groups invest the funds of a single organization, asset managers most often construct and manage portfolios in which individuals, financial advisors, or other pension funds can invest. *Individuals* who purchase specific stocks such as Tesla, can also be considered direct investors.

In many cases, however, individuals will also rely on **intermediaries,** such as *Registered Investment Advisors* (RIAs), to supervise portfolios for the benefit of their clients. Primary responsibilities of an RIA include creating an appropriate allocation between asset classes (equity, fixed income, and cash) and vetting strategies marketed by asset managers.

Active vs. Passive

Generally, asset management can be divided into two approaches: active and passive. Active means that the manager constructs a portfolio with typically less than 100 stocks, each of which is researched, decided upon, and continuously evaluated by a team of investment professionals.

Passive management indicates that the portfolio will be constructed similarly to an index, such as the S&P 500[4]. Most commonly, the manager will rebalance the portfolio quarterly or annually to maintain alignment with the chosen index, but will make few, if any, other adjustments.

One goal of an active investor is to achieve returns greater than a particular index, while the passive strategy goal is to achieve a return equal to a particular index. The differing goals result in a couple of meaningful differences between the two approaches. First, active managers typically have more significant staffing needs than passive counterparts. For any manager, we believe a staff of credentialed, experienced investment professionals, to be a necessary but not sufficient condition for achieving returns above said index.

Second, due to the staff of investment professionals who lend their expertise to investment decisions, active managers like VELA tend to have management fees higher than those utilizing passive strategies. For most VELA strategies, we charge a management fee of .75% per year, compared with perhaps .10% for a passive strategy. [Mutual funds and ETFs have additional costs for services such as legal, audit, custody, and distribution, which results in a Total Expense Ratio.]

Valuation-Centric & Long-Term Oriented

A valid investment approach is necessary, and some approaches that are not time-tested may lack efficacy over the long term. VELA's valuation-centric philosophy was pioneered by Benjamin Graham nearly 100 years ago, and taught to Warren Buffett, who has refined and popularized this philosophy for more than 60 years. Graham's seminal publication, *The Intelligent Investor*, remains a foundational piece of investing literature, and one I frequently recommend to anyone seeking to broaden their investment knowledge.

A core tenet of Graham's philosophy is the belief that good businesses with sound fundamentals will continue to grow over the long term. In the short term, financial markets are often driven by "noise" or emotional volatility as investors react based on limited information. Conversely, our experience suggests that over time, the same markets tend to revert toward a more rational mean which is more closely aligned with each company's underlying value.

Based on this idea, we actively seek out companies with experienced management teams, favorable industry position, and strong balance sheets. Starting with a large investable universe, we apply a rigorous research process to narrow our focus to the companies in which we have the highest long-term conviction. We invest when the price we can pay for those companies offers an attractive, risk-adjusted expected return based on our estimate of intrinsic value. While price may fluctuate over the short term, we believe these companies will likely continue to show positive growth over time[5].

Alignment of Interests

Of equal importance to the individual investment decisions we make on behalf of our clients are the organizational choices and commitments which guide our management of investment portfolios.

Most importantly, the business should be structured such that the motivations of the investment manager are aligned with clients' interests. In my experience, incentive conflicts most often occur with regard to portfolio size, fees charged, and employee accounts.

With respect to portfolio size, managers' revenues increase by growth in assets under management, and such growth may continue past a point which is beneficial to existing clients. Similarly, fees and market impact costs will negatively impact a client's returns. Employee accounts can create mis-alignment, such as devoting time to one's own account, which is time not utilized for clients' accounts.

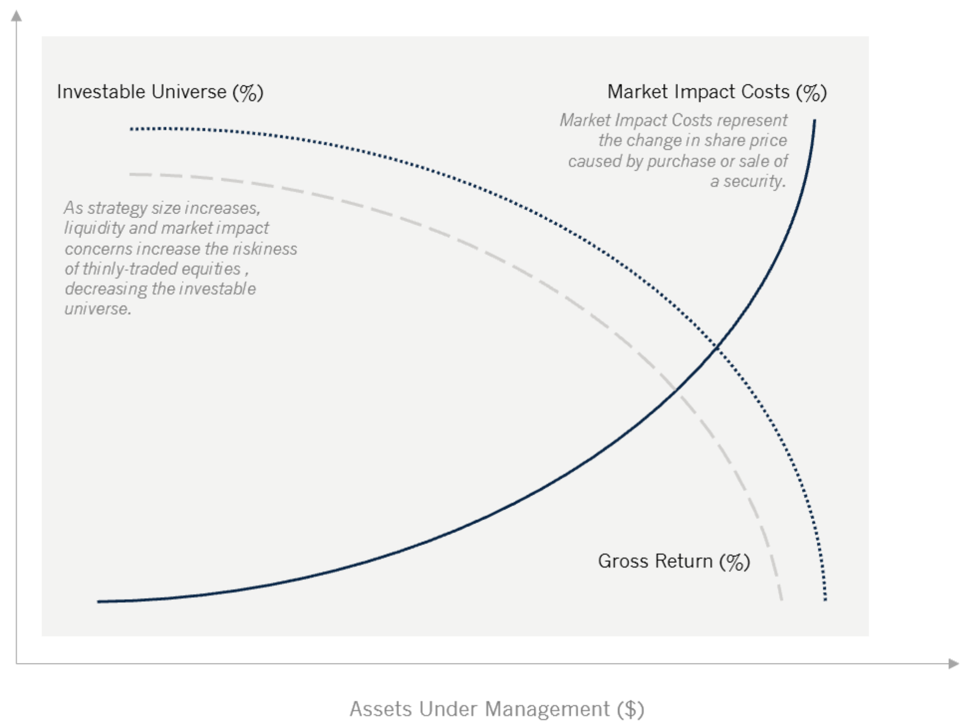
Firm Size

"Size is an Anchor to Performance" ~ Warren Buffett

The above quote succinctly captures a paradox of investing: good firms attract clients; however, if not disciplined in closing investment strategies, their growing assets under management will eventually diminish returns to investors.

Each strategy needs to be limited in size so the portfolio manager can execute without undue burdens of market impact costs. As assets in a portfolio grow, so does the likelihood that a given transaction will meaningfully impact the price of a security. This may be especially true for companies that are thinly traded or smaller market capitalizations, as transactions are likely to cause greater fluctuations in security price. Some securities may be so thinly traded (or conversely, some portfolios so large) that the potential market impact costs negate any meaningful investment return, or the security simply becomes too risky to hold, thereby shrinking the universe of potential investments.

Graph 2. Market Impact Costs



Source: VELA Investment Management, LLC

For example, if you decide to purchase the shares of a stock that is currently at $10.00, and when you finish your average cost is $10.25, then the market impact cost is $.25, or 2.50%. Assuming this as an average for all transactions, and the portfolio turnover is 20% per year, the market impact costs are .50% annually (2.50% x 20% = .50%). When added to a management fee of 0.75%, this becomes a meaningful figure.

At our current size, we have a broader investible universe than our larger peers with minimal market impact costs.

Fees and Expenses

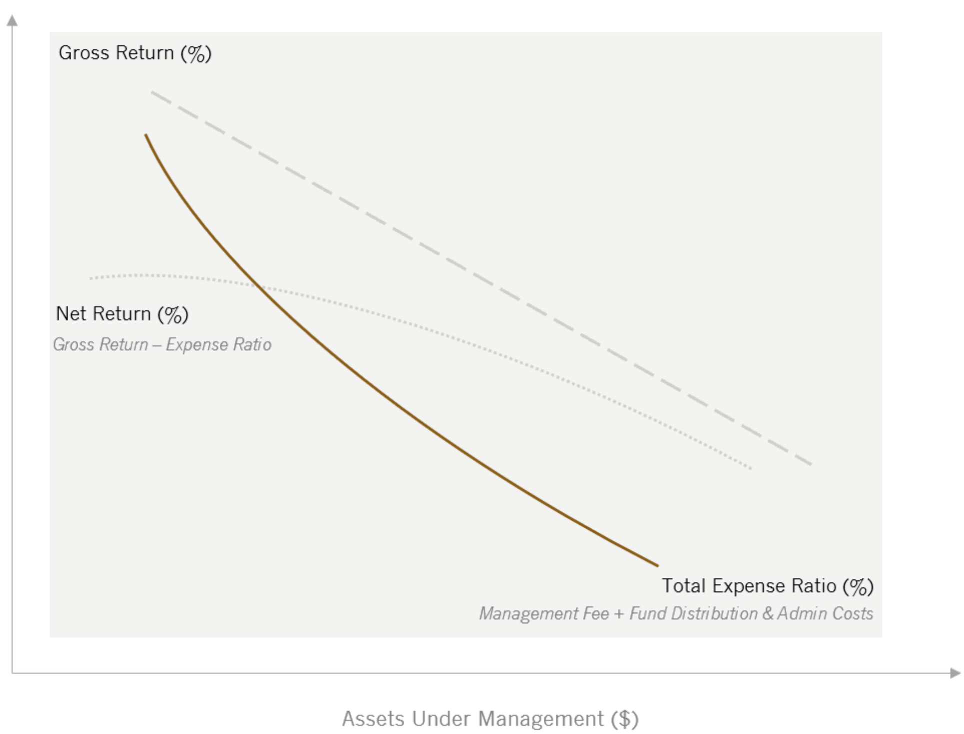
The total cost to the client is comprised of a management fee set by the advisor, and additional 'administrative' expenses associated with the mutual fund[6] for services such as legal, audit, custody, and distribution. The combined fee is the Total Expense Ratio, and each component impacts the client's net return on investment.

To ensure that our interests are properly aligned with those of our clients, our investment management fees are derived in part from our investment management goals. Clients are best served by a fee that is low enough to allow us to achieve meaningful outperformance relative to a passive alternative; yet at the same time a fee that is high enough to allow us to build and maintain an investment team capable of achieving such results.

To continue our market impact example, adding VELA's management fee of .75% + .50% in annual market impact costs totals 1.25%, which reduces the investment return accordingly. So passive strategies have a very large cost advantage, a partial explanation for many managers failing to achieve results greater than the index. Yet, many firms provide index-like returns (or poorer), even while charging active management fees[7].

In contrast to market impact costs, the second cost component, administrative expenses, are inversely related to portfolio size—as assets under management increase, clients benefit from economies of scale.

Graph 3. Total Expense Ratio[8]

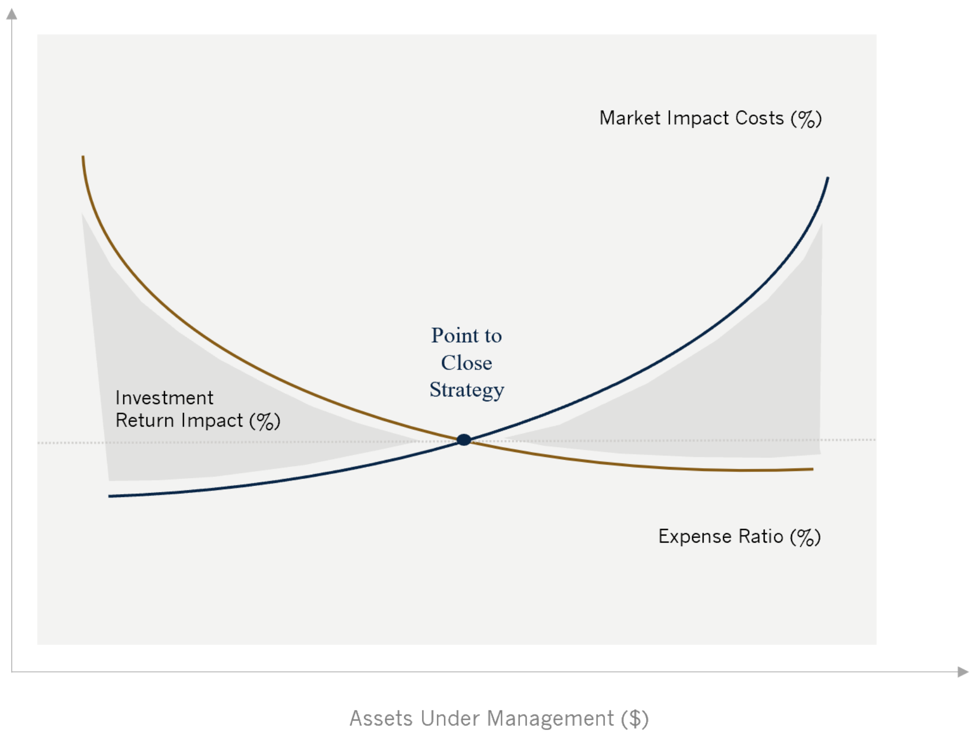


Source: VELA Investment Management, LLC

Adding the administrative cost for VELA's Small Cap Fund (Class I) brings us to a Total Expense Ratio of 0.75% + 0.52% = 1.22%. As the strategy grows, we'd expect to see both a proportional decrease in the total expense ratio and an offsetting increase in market impact cost.

Conceptually, each strategy has an ideal size over which the market impact cost will outweigh any benefit from a reduced total expense ratio. While it is unique to each strategy (the market impact cost for a large cap strategy, for example, will be significantly lower than that for a small cap strategy) and unknowable in exact terms, I believe this size to be far below that at which most managers close their funds to new investors. Limiting fund capacity at an appropriate size is a commitment I have maintained through my career, and a practice we are committed to continuing at VELA.

Graph 4. Point to Close Strategy



Source: VELA Investment Management, LLC

Employee accounts

At VELA, we have a very simple policy: all colleagues can only invest in VELA strategies, which currently span world-wide publicly traded stocks[9]. By investing alongside our clients, we ensure that our portfolio managers will treat their strategies as though it were their own money—because it is. We believe this alignment of interests separates us from all but a few asset managers.

Conclusion

Over my years in the investment industry, I've found great value in building firms, leveraging hard-won knowledge and experience. The mission is always to create an organization optimally structured to help clients achieve their investment goals.

VELA is a culmination of not only mine, but also my partners' collective experience, with each letter representing a core tenet we believe to be necessary for placing client returns in the top twenty percent over the long term:

A **Valuation Centric** approach, practiced by **Experienced Investors** with a **Long Term Temperament,** guided by company policies designed to create an **Alignment of Interests** with our clients.

We remain thankful for the trust and confidence our clients have shown in us, and we are committed to rewarding that trust by striving to achieve superior investment returns while maintaining the highest integrity.

Disclosures

VELA Investment Management, LLC is a registered investment advisor. Information presented is for educational purposes only and does not intend to make an offer or solicitation for the sale or purchase of any specific securities, investments, or investment strategies. Investments involve risk and unless otherwise stated, are not guaranteed. Be sure to first consult with a qualified financial advisor and/or tax professional before implementing any strategy discussed herein. Past performance is not indicative of future performance.

The views expressed are those of VELA Investment Management, LLC as of 7-6-2022 and are subject to change. These opinions are not intended to be a forecast of future events, a guarantee of future results, or investment advice. Third-party information in this report has been obtained from sources believed to be accurate; however, VELA makes no guarantee as to the accuracy or completeness of the information.

VELA Investment Management's advisory fees are disclosed in Form ADV, Part 2A. The total expense ratio for the VELA Funds Class I is: Small Cap VESMX 1.22%; Large Cap Plus VELIX 1.87%; International VEITX 1.22%; Income Opportunities VIOIX 0.95%.

The S&P 500 Index is a composite of 500 of the largest companies in the United States. The S&P 500 Index is unmanaged and does not represent the performance of any particular investment. Indexes are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio.

Footnotes

[1]We define meaningful outperformance as performance greater than one standard deviation in excess of the benchmark, as shown in graph 1 on Page 2.

[2]Article: https://www.wsj.com/articles/90-percent-of-everything-is-crap-venture-capital-marc-andreessen-mosaic-web-silicon-valley-tech-investment-innovation-11642970894

[3]Excerpted from Theodore Sturgeon's 1958 Lecture at NYU: *"When people talk about the mystery novel they mention **The Maltese Falcon** and **The Big Sleep**. When they talk about the western, they say there's **The Way West** and **Shane**. But when they talk about science fiction, they call it 'that Buck Rogers stuff,' and they say 'ninety percent of science fiction is crud.' Well, they're right. Ninety percent of science fiction is crud. But then ninety percent of everything is crud, and it's the ten percent that isn't crud that is important. and the ten percent of science fiction that isn't crud is as good as or better than anything being written anywhere."* Source: https://effectiviology.com/sturgeons-law/

[4]The S&P 500 Index is a composite of 500 of the largest companies in the United States. The S&P 500 Index is unmanaged and does not represent the performance of any particular investment.

[5]We consider five years to be the beginning of statistical significance and use this time period (or greater) in our valuation of each company in which we invest.

[6]VELA offers both Mutual Funds and Separately Managed Accounts (SMAs). For SMAs, we assess only the management fee.

[7] Source: Refinitiv (https://lipperalpha.refinitiv.com/2020/05/the-debate-goes-on-active-vs-passive/)

[8]As shown in graph 2, the decrease in gross return is best represented by a downward sloping curve. We used the straight-line decrease in graph 3 to best demonstrate the effect of total expense ratio on net return.

[9]VELA Employee Trading Policy: *If VELA manages a strategy or fund in a specific asset class (i.e. international or small cap), employees are only permitted to purchase the VELA strategy or fund for that asset class in their personal accounts. Employees are not permitted to purchase non-VELA managed strategies or funds in that asset class for their personal accounts. All employees are prohibited from purchasing any individual equity security (ETFs are considered to be individual equity securities). Employees are permitted to sell individual security holdings however the sale must be precleared or meet the de minimis guidelines. These restrictions apply to all reportable accounts except for: managed accounts, blind trusts, dividend reinvestment, HSAs and employee retirement accounts such as a 401(k), unless it is a self-directed 401(k).*