Managing Volatility Through Manager Selection

In a recent interview with Curian Capital, Steve Young, Chief Investment Officer of Curian, shared his thoughts on the importance of taking a long-term view when it comes to investing, why a disciplined investment process helps investors stay on track to reaching their financial goals, and the benefits of separately managed accounts.

Q: Why is it important to stay focused on the long term when investing?

A: By focusing on the long term, our goal is to replicate the institutional process of managing money, unlike many individual investors, who fall into the trap of focusing on the short term. They're looking for the best-performing investment, and if their investment doesn't perform well for a quarter or two, there's a tendency to sell it and buy another one that has done very well recently. That can lead to selling low and buying high, which is the exact opposite of what investors should be doing.

Steve Young
Chief Investment Officer
Curian Capital

On the other hand, institutions go through a tremendous amount of due diligence when they construct their investment portfolios. By institutions, I'm referring to very large, multi-billion-dollar pools of assets like pension plans, endowments and foundations. They have a specific objective in mind when they choose which asset classes to own and who should manage those assets. They have a thorough knowledge and expectation of how their managers perform in certain market cycles, so when one underperforms because of temporary market biases, they don't panic and sell that manager and invest in another.

Institutions also tend to focus on the longer term. They understand that money managers go in and out of favor. They're comfortable with that, so they're patient knowing they are diversified in order to navigate all market cycles. And those institutional pools of assets historically have had the best performance over time, certainly compared to individual investors. Likewise, we focus on the long term and select managers using a process similar to institutional investors.

Q: And that puts a discipline in place that individual investors might not have?

A: Yes. It starts with putting together a plan — and putting that plan in writing in the form of an investment policy statement — and then hiring an outside institutional consultant to make sure they're staying on track. And when there are bumps in the road, because there always will be with market cycles, having the assistance of a consulting partner helps investors ride through these inevitable downturns.

Q: Asset allocation and diversification form the foundation of Curian's portfolios. Why are those processes so important?

A: Diversifying across different asset classes that complement each other has a tendency to smooth out returns over time — *and* can result in better long-term performance.* For example, if the simple average of the annual returns for two portfolios is identical over a 20-year period, the ending value of the less-volatile portfolio will be higher than that of the more-volatile portfolio. It's simply a statistical fact. If we can smooth out returns by investing in complementary asset classes, our investors' portfolios have the potential to be worth more over time than if those portfolios were less diversified.

* Diversification is no guarantee against loss in a volatile market.

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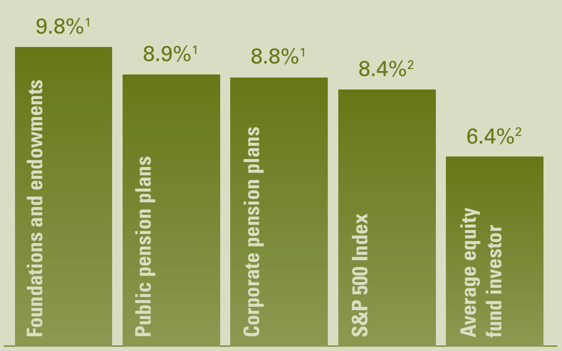
Q: What should investors look for in an active money manager?

A: Although many investors may look at three or four different performance criteria when choosing a money manager, by partnering with independent investment-consulting firm Rogerscasey, we are able to review *dozens* of performance criteria and, at the same time, bring institutional-level resources, time and expertise to the process. We call our process PRooF, which stands for Performance, Repeatability, and Fit. It's much deeper than a focus on performance only. It's understanding the likelihood that the manager's track record can be repeated. As importantly, does the manager *fit* with other money managers on the platform so we can construct a portfolio with complementary characteristics that has the best chance of performing well over time? If not, the result may be unintended risk and negative performance surprises.

10-YEAR AVERAGE ANNUAL GROSS RETURNS 1997–2006



As of 12/31/06

[1] Source: Mellon Analytical Solutions, median returns as cited in Mercer Investment Consulting's "Summary Performance of US Plan Sponsor Funds," December 31, 2006.

[2] Source: DALBAR, Inc., "Quantitative Analysis of Investor Behavior (QAIB)—2007."

Results shown are gross of fees. Fees and expenses related to each group shown will differ depending on the investment objectives and strategy, the size of an account, extent of services rendered, risk, restrictions, tax considerations, etc. This information has been provided by outside sources that we believe are reliable. However, no further verification or adjustments have been made on our part to the data. "Foundations and endowments" is a broad foundation/endowment fund universe comprised of 64 plans of various sizes. "Corporate pension plans" is a broad corporate fund universe comprised of 134 corporate pension plans of various sizes. "Public pension plans" is a broad public fund universe comprised of 34 public pension plans of various sizes. The "S&P 500 Index" is a market-value-weighted index that measures the performance of 500 large-capitalization U.S. stocks. "Average equity fund investor" refers to the universe of all domestic equity mutual fund investors whose actions and financial results are restated to represent a single investor. None of these results include performance in the Curian Program, which launched in March 2003. Past performance is no guarantee of future results.

Q: So performance is an important component of the process, but it's not *the* most important?

A: Yes and no. We focus on performance, but we don't choose our managers based solely on above-average performance. We have to understand at a deep level what the sources of performance are and how the portfolio has performed over various market cycles. Only then can we reduce the potential for a negative performance surprise after we hire them.

A thorough focus on performance traits also helps assess the skill level of the managers. The only way to do that is to listen to how they describe their process and then observe their performance to make sure the two sync up. Interviewing the managers after a comprehensive understanding of performance tendencies is the beginning of the "repeatability" part of our PRooF process. So we do focus on performance, but differently than, say, a mutual fund manager or an individual investor.

Q: How does Curian respond to fluctuating market conditions?

A: With respect to the individual stocks and stock selection when the market goes through volatile times, we put our confidence in the money managers we hire. They're the ones who are following day to day what's going on in the stock market. If there's an opportunity because of volatility, they take advantage of it. They have the resources to focus on daily stock movements.

From Curian's perspective, we have the greatest impact on the types of managers we hire. For example, if we're in an extended bull market and volatility is increasing as it normally does near the end of a cycle, we can find managers who have less volatility in their historic return patterns. Some of the changes we've made in the last couple of years have been with an eye toward managing that volatility through manager selection.

Q: Curian offers different implementation strategies, such as an Active-Core and an Active-Defensive Implementation Strategy. What's an implementation strategy, and why is it important that investors have one?

A: While the strategic asset allocation decision is paramount, we believe individual investors should be just as focused on the **implementation strategy** that makes them most comfortable. The goal of an implementation strategy is to select a mix of managers and investment vehicles that may improve the likelihood investors will stay in the market and stick with their important strategic asset allocation plans over the long term.

This approach shifts the emphasis of portfolio implementation away from trying to find the "best" manager or "best" stock, usually defined as the one with the best performance, toward an approach that concentrates on finding a group of managers and investment vehicles that may better fit an investor's temperament and historical behavior.

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Q: What's the difference between the Active-Core and Active-Defensive Implementation Strategies?

A: Briefly, Curian's Active-Core Implementation Strategy is designed for investors who are looking for consistent, incremental outperformance potential in both up and down markets. These investors are willing to tolerate market volatility and a moderate degree of risk for the prospect of achieving higher returns. They often have longer investment time horizons that will enable them to recoup any short-term losses.

Our Active-Defensive Implementation Strategy provides a deliberate focus on attempting to buffer the negative impact of market declines.* It's designed for investors who have been cautiously intolerant of market volatility — such as retirees and near retirees — and, as a consequence, underallocated to equities or have trouble committing because the stock market is perceived as being too highly valued.

Q: How closely do you monitor the activity of the portfolio managers and the holdings in their portfolios?

A: We follow our portfolio managers very closely and review them formally each quarter. We're not necessarily looking at the individual holdings, rather, we're looking at the characteristics of the portfolio, including performance, that are driven by the individual holdings. We do this comprehensive review with the assistance of Rogerscasey. At a minimum, Rogerscasey is onsite in Denver every quarter with in-depth analysis of each manager.

We look for consistency based on the investment process the manager has employed for years that has caused it to be successful. We want to have confidence that the money manager will be able to repeat that success.

Q: Curian invests in exchange traded funds (ETFs) in several of its portfolios. What are ETFs and why do you like them?

A: ETFs are fairly new in the industry. They're essentially index funds that are traded on the exchanges. Unlike an index mutual fund that's priced at the end of the day, an ETF is traded throughout the day, and you can actually see the price intra-day. It's an efficient way for us to gain access to just about any major asset class.†

We use ETFs in asset classes to complement what we're doing on the domestic equity side. By doing so, we're diversifying our portfolios in an attempt to smooth out returns over time.

Q: From an investor's perspective, why are separately managed accounts an attractive alternative to mutual funds?

A: Separately managed accounts, or SMAs, offer tremendous flexibility that you can't find in mutual funds — starting with transparency. You own the individual securities, so you can monitor them intra-day, if you like.

* There is no guarantee that investors will achieve this objective.
† ETFs will incur certain expenses that include an advisory fee paid to their respective manager.

You also have the flexibility of customizing your portfolio. For example, if you don't want to have exposure to, say, the high-tech industry because you're employed by a high-tech company and have plenty of exposure through your company retirement plan, you could exclude any number of tech-related companies. Just like you can exclude companies for socially conscious reasons.

Furthermore, if your holdings are in a taxable account, you don't inherit the tax history as you do with many mutual funds when you're investing in a separately managed account. When you invest in an SMA, the cost basis of the securities you own is the price on the day they were purchased for your account. In addition, you have the ability to harvest tax losses throughout the year and potentially minimize the taxes that you pay each year. You don't have that degree of flexibility with mutual funds.

Q: Advisors usually recommend that investors increase the bond component of their portfolios as they near retirement or have retired. What do you think of that strategy?
A: Generally, I think that as you get into retirement, you probably need to be more conservative. The problem is, many investors go a little bit too conservative, and their portfolios are over-weighted in fixed income. When people retire, they have to realize that they could need an income stream for the next 20 years or more. They also want to maintain their purchasing power and their standard of living. And, of course, inflation will eat that away.

I believe one of the best ways to offset inflation is to invest in those asset classes that keep pace with or outpace inflation, and high-quality fixed-income is not that asset class. Making sure there is some exposure to equities can offset the ravages of inflation over time. Maintaining a meaningful exposure to the equity asset class, we think, makes perfect sense for many retirees.

Q: Is there anything else you'd like to share with our readers?
A: I'd just like to reiterate that a focus on institutional investing is key to success performance-wise. Also, although some mutual funds have been around a long time, technology has evolved to the point at which there's more than just mutual funds out there — like separately managed accounts that have a lot of significant benefits to either help you keep more money in your pocket or allow you to tailor your portfolio to your specifications. Obviously, as a separately managed account platform, Curian is one of those solutions.