

>>> Test Your Perceptions:

1. From 1984 to 2007, Portfolio Managers' best ideas outperformed the rest of their portfolios, as well as the market by:

- a. 100 basis points per year
- b. 300 basis points per year
- c. 400 to 1,000 basis points per year
- d. Did not outperform the market during this period

2. Focus Funds increase portfolio risk.

- a. True
- b. False

3. The best ideas that come from active managers are stocks that are:

- a. Large companies with well known brands
- b. Common across the majority of the managers
- c. Smaller, less liquid and less popular among portfolio managers

You can learn about where active portfolio managers find a performance advantage by reading this paper.

For the correct answers turn to page 10.

Summer 2010

Unconventional Wisdom

Focused mutual funds have the potential to outperform without increasing portfolio risk

The loss of an estimated \$20 trillion of wealth from late 2007 through March 2009 has caused many investment advisors to reassess the conventional wisdom that has guided portfolio allocation for decades. One solution that is receiving increased attention is the inclusion of focused mutual funds—either as satellite holdings or core replacement options—in portfolio allocations. >>>

Much of the enthusiasm for incorporating focused funds into asset allocation strategies is being driven by recent academic studies. The research shows that focused funds have the potential to significantly outperform markets, as well as more highly diversified mutual funds, without increasing risk. For the purposes of this paper, focused mutual funds are defined as portfolios that concentrate assets in managers' best investment ideas. The research reviewed shows that:

1. **High conviction investment ideas have outperformed:** The highest conviction ideas of typical active mutual fund managers consistently outperformed the rest of the positions in their portfolios, and the market, by about 4 to 10 percentage points per year from 1984 through 2007.¹
2. **Highly concentrated funds have outperformed:** Fund managers who concentrate portfolio assets in their highest conviction ideas have outperformed managers of more highly-diversified portfolios over a 24 year period.²
3. **Focused funds have not had higher risk:** Portfolios that included only managers' best ideas generally delivered strong returns without added risk.³

In addition to providing a brief overview of newer academic findings this paper will explore the advantages enjoyed by focused fund managers, examine the reasons focused funds are not more widely adopted in the mutual fund industry, and provide some recommendations for investment advisors to consider.

1. High Conviction Investments Have Outperformed

Most mutual fund managers will acknowledge that they have greater conviction in their top five investment ideas than in ideas 25 through 100. So it should be interesting to learn that recent research shows managers' best ideas systematically outperform other positions in their portfolios, as well as the market.

The magnitude of the outperformance is striking. *Best Ideas*, a study conducted by Bernard Cohen of Massachusetts Institute of Technology, Christopher Polk of the London School of Economics, and Bernhard Silli of Goldman Sachs, found that between 1984 and 2007, mutual fund managers' 'best ideas'—the ideas in which they had the greatest conviction—outperformed the market by approximately 4 to 10 percentage points per year depending on the benchmark.⁴

¹ Randolph B. Cohen, Christopher Polk, and Bernhard Silli, *Best Ideas*, MIT, LSE, Goldman Sachs, April 20, 2010.

² Klass Baks, Jeffrey Busse, and Clifton Green, *Fund Managers Who Take Big Bets: Skilled or Overconfident*, American Finance Association 2007 Meetings Paper.

³ Ibid.

⁴ Cohen, Polk, and Silli.

The study found that best ideas generated:

“...Statistically and economically significant risk-adjusted returns over time but they also systematically outperform the rest of the positions in managers’ portfolios... this result is consistent across many specifications: different benchmarks, different risk models, and different definitions of best ideas.”⁵

>>> **Methodology of the Best Ideas Study**

Cohen, Polk, and Silli have measured performance in two distinct ways. They constructed and evaluated the performance of best ideas portfolios and best-minus-the-rest portfolios.

Best Ideas Portfolio

The researchers began by creating and tracking portfolios that included only mutual fund managers’ best ideas. These holdings were equal-weighted unless more than one manager shared the idea. In those cases, the stock was weighted accordingly. The study’s authors described best ideas portfolios in this way:

The best ideas portfolios...do not consist of just a few names that are hot on Wall Street. [These portfolios] represent the opinions of hundreds of managers each of whom independently found at least one stock about which they appeared to have real conviction.⁶

The best ideas portfolios were rebalanced quarterly to reflect new information as it became available to managers. Best ideas portfolios generated statistically and economically significant risk-adjusted returns over time, systematically outperforming other investments held in

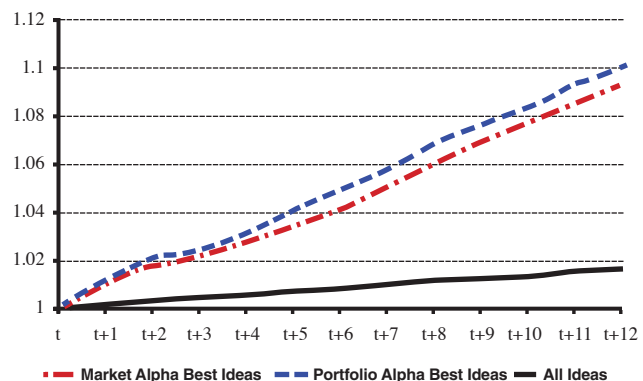
⁵ Cohen, Polk, and Silli.

⁶ Ibid.

**CHART 1.
BEST IDEAS PORTFOLIOS OUTPERFORM**

The risk-adjusted, cumulative, buy-and-hold, abnormal returns (measured by market alpha and portfolio alpha) of best ideas portfolios were attractive relative to the performance of all stocks held by the mutual fund industry at the same points in time between 1984 and 2007.

Source: Best Ideas, April 2010.



managers' original mutual fund portfolios by 1.2 to 2.6 percentage points per quarter depending on the benchmark employed.⁷

Best-minus-the-rest portfolios

Next, the researchers created and evaluated best-minus-the-rest portfolios. One set of best-minus-the-rest portfolios took a long position in each mutual fund manager's best idea and shorted the remaining stocks in the portfolio; others took long positions in managers' three and five best investment ideas while shorting the remaining stocks in the portfolio. All portfolios were weighted by the size of a manager's holdings in a position, and then equally-weighted across managers. Best-minus-the-rest portfolios outperformed other stocks held in the original mutual funds—and the market. Outperformance ranged from 0.6 to 1.25 percentage points per quarter when managers' top three ideas were measured against other portfolio holdings.⁸

2. Highly Concentrated Funds Have Outperformed

Not all mutual fund managers are willing to make big bets by concentrating their portfolios' assets in a few good ideas. Those who do, however, have the potential to outperform the market, as well as more highly diversified mutual funds.⁹ Baks, Busse, and Green, in a study known as, '**Big Bets**,' found that domestic stock portfolios with strong weightings in a relatively small number of holdings delivered higher returns—both before and after expenses—than portfolios which held more uniformly weighted positions. These focused, '**Big Bets**' portfolios delivered approximately 30 basis points of additional performance each month, or roughly 4 percentage points of additional return each year.¹⁰

3. Focused Funds Have Not Had Higher Risk

Many financial professionals were taught that focused mutual funds expose investors to greater risk than more highly-diversified options. Generally, this is not the case. Research shows that holding 20 to 50 stocks can reduce unsystematic risk significantly.¹¹ This concept is illustrated in Chart 2 on the next page.

In late 2009, the *Wall Street Journal* published an article that included research from Morningstar, Inc, which demonstrated that mutual fund portfolios with 40 or fewer holdings "aren't more volatile than more diversified funds, on average, and some are surprisingly steady despite their small number of holdings."¹²

In a separate study, Morningstar analyzed the standard deviation of the most diverse and the

⁷ Ibid.

⁸ Ibid.

⁹ Klass Baks, Jeffrey Busse, and Clifton Green, **Fund Managers Who Take Big Bets: Skilled or Overconfident**, American Finance Association 2007 Meetings Paper.

¹⁰ Ibid.

¹¹ John Campbell, Martin Lettau, Burton Malkiel, and Yexiao Xu, **Have Individual Stocks Become More Volatile**, *The Journal of Finance*, Vol. LVI, No. 1, February 2001.

¹² Larry Light, **Okay, Now Concentrate**, *The Wall Street Journal*, October 6, 2009.

most concentrated mutual fund portfolios between 1992 and 2006.¹³ Their work showed that volatility was similar for the two groups, refuting the idea that concentrated portfolios, as a whole, are riskier than more diversified offerings.

The Structural Advantages Of A Focused Approach

Academic research shows that focused mutual funds have the potential to produce strong returns without added risk...but a key question is why? The answer may be quite simple. Focused funds hold fewer stocks than typical mutual funds, so focused fund managers have more time to research and understand the stocks they hold or are considering adding. This should give focused fund managers informational advantages that may aid in the identification of mispriced securities. Focused fund managers also can be more discriminating, avoiding stocks or sectors that they do not like, and focusing attention on a narrow band of companies or securities that meet their strict criteria.

In his 1993 letter to shareholders, Warren Buffet described the philosophy of many focused fund managers when he said:

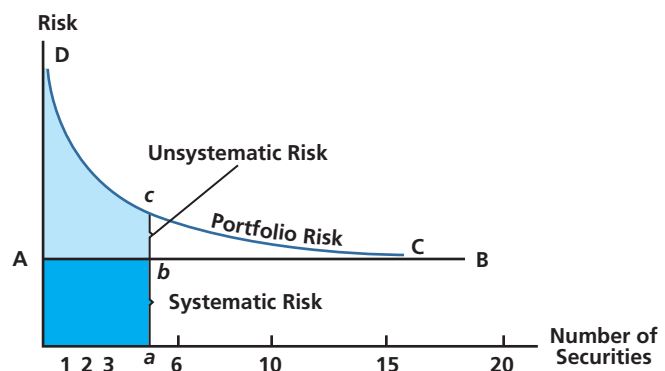
“Charlie and I decided long ago that in an investment lifetime it’s just too hard to make hundreds of smart decisions...Therefore, we adopted a strategy that required our being smart—and not too smart at that—only a very few times. Indeed, we’ll now settle for one good idea a year... The strategy we’ve adopted precludes our following standard diversification dogma. We believe that a policy of portfolio concentration may well decrease risk if it raises, as it should, both the intensity with which an investor thinks about a business and the comfort-level he must feel with its economic characteristics before buying into it.”

¹³ Ibid.

¹⁴ Campell, Lettau, Malkiel, and Xu.

CHART 2. UNDERSTANDING SYSTEMATIC AND UNSYSTEMATIC RISK

Unsystematic risk may be eliminated by holding relatively few stocks. Systematic risk cannot be eliminated. Research has shown that holding 20 to 50 stocks can reduce unsystematic risk by 90 percent to 95 percent.¹⁴



>>> Research provides evidentiary support

While it makes intuitive sense that having better information would produce benefits for investors, academic research supports the idea, as well. It suggests that focused fund managers are more confident and have longer-term outlooks.

Information advantages: In general, managers who hold fewer companies have more time and greater incentive to develop complete information about each company in which they invest. A study by Kacperczyk and Seru found that managers who rely less on public information when making buy and sell decisions deliver significantly higher returns.¹⁶

More confident stock selection: Baks, Busse, and Green found that managers who invested a disproportionate amount of assets in their best ideas were confident about their ability to assess the merits of investment options both inside and outside of their portfolios.¹⁷

A long-term outlook: A study by Kacperczyk, Sialm, and Zheng found that managers of concentrated portfolios are able to add value by exploiting long-term mispricings in the marketplace. As a result, they delivered strong performance with lower turnover during the 24-year period studied.¹⁸

Why Isn't Focused Investing The Industry Standard?

Best Ideas showed that “the typical fund manager has a small number of good investment ideas that provide positive alpha... The remaining ideas in the typical managed portfolio add little or

¹⁵ Cohen, Polk, and Silli.

¹⁶ Marcin Kacperczyk and Amit Seru, **Fund Manager Use of Public Information: New Evidence on Managerial Skills**, *The Journal of Finance*, Volume LXII, No. 2, April 2007.

¹⁷ Baks, Busse, and Green.

¹⁸ Marcin Kacperczyk, Clemens Sialm, and Lu Zheng, **On the Industry Concentration of Actively-Managed Equity Mutual Funds**, *Journal of Finance*, August 2005.

ON ADDING VALUE FOR INVESTORS

Managers who concentrate assets in high conviction ideas can add more value than managers who diversify too broadly. The authors of Best Ideas said:

“Modern portfolio theory says that any portfolio of stocks that maximizes the [Capital Asset Pricing Model] information ratio is equally good for investors. But in truth, if the manager offers a portfolio with small weights in the good ideas and a very large weight in the market (or a near-market portfolio [that holds] zero-alpha or near zero-alpha stocks) the results for investors will be entirely unsatisfactory. The small allocation that investors make to any given manager combined with the small weight such a manager places in good ideas, means that the manager adds very little value.”¹⁵

no alpha.”¹⁹ This begs the question: Why do managers include investments that are not best ideas in their portfolios? There are a variety of explanations.

>>> Flawed financial incentives

In general, mutual fund managers are paid a fixed percentage of total assets under management. This creates an incentive for managers to emphasize growth in fund assets over performance. Since investors tend to stay in mutual funds even when they deliver mediocre performance,²⁰ few managers are willing to turn away new investors when cash inflows are more plentiful than high conviction investment ideas.

>>> Career risk

John Maynard Keynes observed “Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally.” Managers who underperform their benchmarks for any one- or two-year period may face the threat of termination. As a result, many managers have incentives to avoid unsystematic risk, as well as a tendency to herd into popular sectors.²¹

>>> Legal and regulatory requirements

The ‘Prudent Man Rule’ makes it attractive for portfolio managers to have well-diversified portfolios. Prudent protection of capital necessitates the avoidance of unwarranted risk.²² In addition, mutual fund managers are guided by specific regulations that were designed to prevent mutual funds’ assets from becoming too concentrated.²³ As a result, managers cannot invest an unlimited amount of assets in a few holdings.

Managers who have the incentives, confidence, and ability to concentrate assets in their best ideas provide attractive opportunities for investment advisors seeking value-added active portfolio management.

Active Management Doesn’t Add Value—Does It?

Since Michael Jensen published “Risk, the Pricing of Capital Assets, and the Evaluation of Investment Portfolios” in 1969, the idea that active management rarely adds value has become widely accepted. Empirical evidence gathered in later studies often confirms that actively-managed mutual funds tend to underperform their benchmark indices once expenses have been paid.

This conclusion may be overly generalized. Studies that clearly define active management and then measure performance, have found that there is a strong correlation between active management and fund outperformance. For example, Cremers and Petajisto defined active mutual fund managers as those whose portfolios differed significantly from their benchmarks. These managers outperformed by 1.51 to 2.40 percentage points each year between 1979 and 2004.²⁴

There are many reasons that actively managed mutual funds deliver average performance (See Why isn’t focused investing the industry standard?). However, managers who have the confidence to focus on their best ideas have the potential to deliver the performance investors seek.

¹⁹ Cohen, Polk, and Silli.

²⁰ Erik R. Sirri and Peter Tufano, **Costly Search and Mutual Fund Flows**, Journal of Finance, Vol. 53, Issue 5, 1998.

²¹ Judith Chevalier and Glenn Ellison, **Career Concerns of Mutual Fund Managers**, NBER Working Paper Series, August 1998.

²² Baks, Busse, and Green.

²³ Cohen, Polk, and Silli.

²⁴ K.J. Martijn Cremers and Antti Petajisto, **How Active Is Your Fund Manager? A New Measure That Predicts Performance**, Yale School of Management, March 31, 2009.

Final Thoughts

Conventional wisdom is a set of beliefs that is accepted by a group of people. Once these beliefs become ingrained, few take the time to evaluate their substance. In the investment industry, conventional wisdom tells us that highly diversified mutual funds have the greatest potential to deliver attractive risk-adjusted returns. A review of recent research, however, shows that a more unconventional approach to mutual fund management—concentrating assets in managers’ best ideas—has the potential to provide investors with better risk-adjusted returns. Researchers found that:

The Value Of Boutique Management Firms

Where can financial professionals find managers who are willing to buck conventional wisdom and create portfolios that have the potential to deliver outperformance? Boutique investment firms often attract managers who have left larger more traditional work environments because they did not want to be constrained by the limits of conventional wisdom. They tend to have great passion for markets and investing. Moreover, they have conviction in the investment processes they’ve developed and fervent commitment to disciplined execution of those processes. These qualities have the potential to produce attractive investment results for investors whose risk profiles match a firm’s offerings.

- **High conviction investment ideas have outperformed** the market by about 4 to 10 percentage points per year over a 24-year period.²⁵
- **Highly concentrated funds have outperformed**, generating more alpha and outperforming more highly diversified mutual funds.²⁶
- **Focused funds have not had higher risk**, standard deviations for the most diverse and the most concentrated fund portfolios were similar between 1992 and 2006.²⁷

>>> Focused funds are not panaceas

While concentrated portfolios have potential to deliver outperformance without increasing risk, they are not panaceas. These funds may:

- **Be less nimble.** Since best ideas tend to be smaller and less liquid, concentrated portfolios may be less nimble. Investors should plan to hold focused funds for longer periods of time.
- **Deliver uneven performance.** Many concentrated portfolios have little or no exposure to certain market sectors. Consequently, if a sector in which the fund has little exposure gets ‘hot,’ a concentrated portfolio may lag its benchmark for a period of time.
- **Reflect investor irrationality.** The movement of a single stock in a positive or negative direction—based on rational or irrational investor behavior—may have a greater affect on a more concentrated portfolio.

Although these characteristics are unlikely to have long-lasting effects on performance, they may have a significant influence over shorter periods of time. As a result, more concentrated funds generally should be longer-term portfolio holdings.

²⁵ Cohen, Polk, and Silli.

²⁶ Baks, Busse, and Green.

²⁷ Light.

Consider Using Focused Funds As Satellites Or Alternatives To Core Holdings

Advisors who are looking for ways to improve performance potential may want to consider incorporating focused funds into their asset allocation strategies. Focused funds may be used as:

- **Satellite holdings:** A single focused fund may be used as a satellite holding to boost portfolio performance potential. The *Best Ideas* study supports the idea of using concentrated portfolios as satellite holdings. It found that putting a modest percentage of assets in a concentrated mutual fund of best ideas was likely to improve performance potential.
- **Core replacement options:** Since portfolio managers' best ideas rarely overlap,²⁸ as you can see in Chart 3, several focused funds can be used in place of one highly-diversified core fund to improve performance potential without increasing risk. The *Big Bets* study provides support for the idea of replacing a highly diversified core holding with several focused funds. The study concluded that investing in portfolios of focused funds, instead of more highly diversified funds, could enhance overall portfolio performance.²⁹

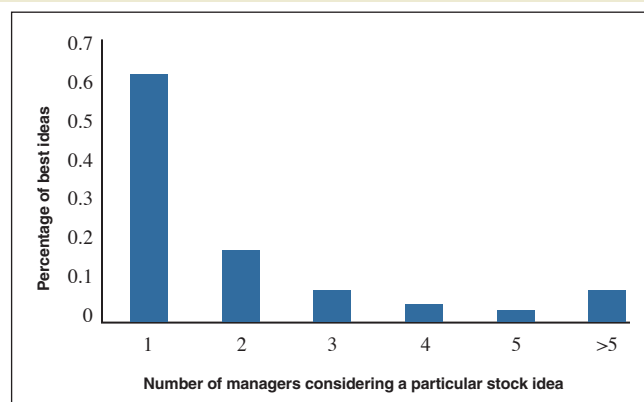
Focused funds are differentiated and often overlooked mutual fund options. If you would like to learn more about incorporating focused funds in your allocation strategies, please contact FBR Fund Advisers at 888.200.4710.

²⁸ Cohen, Polk, and Silli.
²⁹ Baks, Busse, and Green.

CHART 3. FUND MANAGERS' BEST IDEAS RARELY OVERLAP

Mutual fund managers' best ideas tend to be distinct. Over a 23-year period, about 62 percent of best ideas were unique to one manager, while just 7 percent were shared by five or more managers.

Source: *Best Ideas*, April 2010



Glossary

Abnormal return: The difference between a portfolio's return and that of its benchmark index. When the return is positive, the portfolio performs better than the index. When the return is negative, the portfolio has performed worse than the index.

Alpha: Measures performance on a risk-adjusted basis by comparing a mutual fund's risk-adjusted performance to the performance of a benchmark index. Any additional return delivered by the mutual fund is the fund's alpha.

Systematic risk: The risk inherent to the entire market or segment of the market. Changes in interest rates, recession, and wars are sources of systematic risk because they affect the entire market and cannot be avoided through diversification.

Unsystematic risk: The risk that is specific to a company or industry. For instance, if airline pilots went on strike, airline industry stocks would be affected. Unsystematic risk can be reduced through diversification.

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We believe that quality investment products begin and end with a consistent investment approach and discipline. We strive to give investors exposure to segments of the market that offer long-term potential for growth. We attempt to uncover companies that believe in what we believe—that durable equity returns are driven by consistent profitability. Consistent profits begin with conservative accounting, an aversion to debt, a low cost operating structure, an uncomplicated business plan, and an overall philosophy of building for the long-term.

In sum, FBR Asset Management is about Respecting Your Money®. We understand the capital markets are not always favorable and we strive to preserve capital during those turbulent times. We believe losing less money in difficult markets is more important than making the most in rising ones. We continue to diligently seek new investment opportunities without undue risk.

Our goal is to give your money the best chance to achieve returns that are balanced, mindful of the downside and sustainable over the long-run.

QUIZ ANSWERS: 1. C. 400 to 1000 basis points per year¹ 2. B. False² 3. C. Smaller, less liquid and less popular among portfolio managers³

¹ Randolph B. Cohen, Christopher Polk, and Bernhard Silli, Best Ideas, MIT, LSE, Goldman Sachs, April 20, 2010.

² Klass Baks, Jeffrey Busse, and Clifton Green, Fund Managers Who Take Big Bets: Skilled or Overconfident, American Finance Association 2007 Meetings Paper.

³ Randolph B. Cohen, Christopher Polk, and Bernhard Silli, Best Ideas, MIT, LSE, Goldman Sachs, April 20, 2010.

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