The Wall Street Journal reported recently that Oprah Winfrey has hired a “star” manager to run her very substantial investment portfolio. According to the article, the manager, Peter Adamson, has employed the “endowment” approach (made famous by David Swensen of Yale University) at the Broad Foundation to achieve a track record of “3%-4% above the appropriate indices.” Oprah considers it a coup to have hired such a talented individual to run her personal investments.

My initial reaction to this news was to think about how many rich people thought it was a coup to have Bernie Madoff as their investment manager—before they realized so tragically that it was not. I don’t mention this to impugn Adamson’s reputation. As far as I know, he’s an honest, smart, and talented individual. But the common denominators are a perceived “talent” at managing money (based on claims of extraordinary performance) and a reliance on complex, opaque, and relatively illiquid investment strategies to achieve abnormal returns.

I’ve discussed the risks of the endowment approach in previous articles and referenced an eloquent rebuttal to the approach in last month’s Asset Class (“The Big Lie”). So I’m intrigued by Oprah’s decision. It highlights an interesting pattern we see all the time with very successful business people and professionals, especially doctors and attorneys. Since their talents have paid off in building their businesses or practices, they believe talent at picking stocks, timing markets, or selecting superior hedge fund managers should pay off as well—despite an abundance of research that proves otherwise. Why they choose not to hedge their talent-dependent business risk with much more reliable capital markets risk in their investment portfolios is a mystery to me.

Oprah’s Bets

Oprah Winfrey is worth $2.5 billion. She has worked very hard and very smart to build her media empire. She has hit her share of “home runs” in a business she really understands and has significant control over. Ultimately, however, her success is based on one person: Oprah. She is the talent, the personality, the media-savvy maven behind her success. She has diversified her company, Harpo Productions, somewhat by betting on the talents of Dr. Phil and Rachael Ray, but its future growth and profitability is still highly dependent on her talents.
You cannot create a structure or set of rules to repeat Oprah’s success, any more than you can do the same with her star money manager. For every Adamson who has been talented (or fortunate) enough to pick equally talented hedge fund managers, there are hundreds of others who did not—at great cost to their clients.

Were the money managers and consultants who recommended Bernie Madoff considered any less talented than Adamson prior to the detection of Madoff’s fraud? Were those who recommended Amaranth, Long-Term Capital, Marin Capital, or George Soros’ Quantum Fund less talented? By all accounts they were not. Yet all these funds ultimately failed.

We know the odds of selecting a mutual fund that beats the market in any given year is about 1 in 4. When you extend the time period to 10 or 20 years, the odds grow even slimmer. And the track records, investment strategies, and holdings of mutual funds are public and audited.

One could argue that venture capital, private equity, and hedge fund managers (core components of Adamson’s endowment approach) have advantages over mutual fund managers, but there are also additional risks. They are virtually unregulated, much less transparent, less diversified, highly leveraged, illiquid, impose much higher fees and expenses, and there is greater chance for fraud. Given these “qualities,” I would suggest the chance of market-beating performance is much less with hedge funds than mutual funds, albeit the potential upside is higher with the former. With hedge funds, the choice is to accept many strikeouts for an occasional blast into the center field bleachers.

**Stars Fade**

It’s not clear what percentage of Oprah’s total estimated wealth is represented by her investment portfolio, but let’s assume it’s $1 billion. That should be plenty of money to support her lifestyle (she doesn’t appear to be an Elton John or Michael Jackson) and provide for family, friends, or charitable causes for generations to come. But simply investing the money in risk-free U.S. Treasury bills would not provide the growth above expected inflation necessary to support anticipated withdrawals in the future. So Oprah will need to subject the portfolio to some risk to earn, say, 4% over the rate of inflation (a 7% total return). She has a choice: she can bet on talent or she can bet on markets.

I’m not sure how old Oprah’s new money manager is or the ages of the hedge fund managers he will hire on her behalf, but “stars” are mortal. What will she do if Adamson retires or dies in the next twenty years? What if he or the hedge fund managers he selects suddenly and unexpectedly fail to produce superior returns? The investment business is highly competitive, and these managers work incessantly to discover market inefficiencies that they can exploit before everyone else does. This, of course, creates more efficiency in securities pricing—a vicious circle that eventually turns all stars into mere mortals.

It is therefore highly likely that over the next couple of decades Adamson will cycle through many different hedge fund managers in pursuit of returns “3%-4% above the appropriate indices” and Oprah will, in turn, replace Adamson as he fails in his quest. It’s not even clear why Oprah feels she needs such a high return (assuming the “appropriate indices” are stock market indices), but one thing is for sure: realizing that kind of return for ten or twenty years or more is extremely rare without taking extraordinary risks. What’s the point? This whole process, with all its dislocations, anxiety, risks, and cost is totally unnecessary.

**Markets (Economies) Grow**

As Table 1 illustrates, a 4% real return is more likely to be achieved by investing in simple, balanced, and highly diversified asset class portfolios. A simulated balanced “market” portfolio generated the 4% return premium over a risk-free investment with only 60% exposure to stocks over the past 82 years.

By taking the stock diversification a step further by adding a tilt to small cap and value stocks, the expected return premium increases to over 6% (for a total

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**Table 1: Markets, Not Talent**

<table>
<thead>
<tr>
<th>Investment</th>
<th>Annual Return 1928-2009</th>
<th>Annual Return Premium over T-Bills</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inflation (CPI)</td>
<td>3.1%</td>
<td>-</td>
</tr>
<tr>
<td>U.S. Treasury Bills</td>
<td>3.7%</td>
<td>-</td>
</tr>
<tr>
<td>Five-Year Treasury Bond Index</td>
<td>5.3%</td>
<td>+1.6%</td>
</tr>
<tr>
<td>Total Stock Market Index (CRSP 1-10)</td>
<td>9.3%</td>
<td>+5.6%</td>
</tr>
<tr>
<td>Blended Stock Market Index*</td>
<td>11.5%</td>
<td>+7.8%</td>
</tr>
<tr>
<td>Balanced “Market” Portfolio*</td>
<td>8.3%</td>
<td>+4.6%</td>
</tr>
<tr>
<td>Balanced “Blended Market” Portfolio*</td>
<td>9.8%</td>
<td>+6.1%</td>
</tr>
</tbody>
</table>

*The “Blended Stock Market Index” is 30% CRSP 1-10 Index, 30% DFA U.S. Large Value Index, and 40% DFA U.S. Small Value Index. The Balanced “Market” Portfolio is a mix of 40% 5-Year Treasury Bonds and 60% CRSP 1-10 total stock market index. The Balanced “Blended Market” Portfolio substitutes the 60% allocated to the CRSP 1-10 total stock market index with a blend of 18% CRSP 1-10 Index, 18% DFA U.S. Large Value Index, and 24% DFA U.S. Small Value Index. Past performance is not a guarantee of future returns. Indices are not available for direct investment.
expected return of 9%). This suggests that Oprah could lower her stock exposure even further and still achieve a very reasonable rate of return after inflation.

OK, so maybe Oprah isn’t thinking in terms of 82 years (although if the money is going to charities, she should). What if we divide the 1928-2009 period into 20-year pieces starting every month since the beginning? Table 2 shows the balanced “market” portfolio beat T-bills on average by 5.2% per year, while the balanced “blended market” portfolio beat T-bills by 7.0% per year over the average 20-year period.

Furthermore, the balanced “blended market” portfolio beat T-Bills by 4% or more in 96% of the periods (the balanced “market” portfolio achieved this only 66% of the time).

Of course, critics will suggest that maybe this 82-year market stretch was special and we can’t rely on these kinds of returns in the future. Or that the small cap and value premiums aren’t reliable. They could be right. Of course, this is what they said about the “Three-Factor” research that Eugene Fama and Ken French produced at the University of Chicago in the early 90s. Their seminal paper on the subject was published in 1992 using market data up to 1991. So let’s look at two periods, 1928-1990 and 1991-2009, and see what we find (Table 3). The returns for the first 63 years are remarkably similar to those for the last 19. Different challenges, same market returns.

Where would you place your bets? On a very efficient market-based economy or on “star” money managers who suggest it’s flawed enough to exploit, despite overwhelming evidence to the contrary?

By the way, we find very similar risk and return characteristics in the non-U.S. developed markets, as well as small cap and value return premiums in emerging markets. Global diversification has been shown to reduce portfolio volatility while maintaining the expected return of a U.S.-only portfolio. I excluded foreign markets in these illustrations only because the data does not extend back to 1928.

### Hedge Rather Than Swing for the Fences

A balanced, “blended market” portfolio would serve as a hedge against Oprah’s “talent” portfolio of concentrated Harpo Productions stock.

Harpo Productions is where her immense talent can still pay off in a big way—as long as she remains in control. Once she sells Harpo to a big, publicly traded media company like Disney, GE, or News Corp., her risk will shift to arguably lesser talents like Dr. Phil and Rachael Ray and to the corporate executives who run these companies (sometimes into the ground). Robert Johnson’s experience (see the box on the next page) should be a wake-up call for Oprah, and there’s an endless supply of similar stories about the famous and not-so-famous over the course of history.

Along with anecdotal evidence, we also have statistical tools that suggest that concentrated stock portfolios are just not worth the risk. David Booth, the co-founder of Dimensional Fund Advisors and the major benefactor of the University of Chicago’s Booth School of Business, presented research on concentrated stock positions at an advisor conference last year. Using the actual monthly returns for the market (CRSP 1-10 index) since June 1926 and the same returns for a concentrated portfolio (the average of all concentrated portfolios must equal the market), Booth applied a standard deviation (volatility) for the concentrated portfolio twice as high as the market. He then ran one million “bootstrap” simulations of the data.

He found that while the concentrated portfolio had both higher highs and lower lows (what we would expect from the more volatile concentrated portfolios), the average outcome was much more skewed toward below average returns. As a result, the market portfolio beat the concentrated portfolio in total growth in 58% of the one-
year periods, 81% of the 10-year periods, and 92% of the 25-year periods. Furthermore, after just 10 years, the market portfolio had grown on average almost three times greater than the far riskier concentrated portfolio.

**Why, Oprah?**

These results beg the obvious question: if you don’t need to take the risk of another talent-dependent or concentrated stock portfolio (i.e., you’ve already hit your home run, you’re rich enough already, and the money is for future generations of your family and/or charities), **why take the risks?** A diversified “market” portfolio that spreads risk among 8,000 companies globally and tilts toward the additional *compensated* risk factors of small cap and value stocks has a much greater chance of meeting reasonable and rational financial goals over longer periods of time.

Other than in her business, Oprah’s talent dollars would be better invested in an investment counselor who will tell her the truth about real-world investment odds; assist her in structuring an appropriate, low-cost asset class portfolio; provide sound and consistent counsel during volatile periods; and help her define, grow, and preserve the financial legacy she deserves. We at Equius Partners stand ready to assist her. Phone lines are open.


**Avoiding Another BET**

It’s interesting to note that things didn’t turn out as planned for another media tycoon who preceded Oprah on the billionaires list. Robert Johnson built his media empire into a $3 billion business and sold it to Viacom in 2000. His brainchild was the Black Entertainment Television (BET) network. Unfortunately, after successfully betting on his and his team’s talents at BET, he continued to bet on the managers at Viacom. He held on to the stock (and that of CBS when it was spun off in 2006) and watched it decline along with his investments in real estate, hotels, and banks. *Forbes* magazine now estimates his net worth at $550 million (after splitting assets with his ex-wife).

It’s clear that Johnson believed his talents in media were translatable to managing real estate and concentrated stock positions. Instead of “banking” his home run by investing very broadly (and passively) in the capitalistic system that was so good to him, he continued to swing for the fences with concentrated bets. While $550 million is a massive fortune and likely to finance his lifestyle just fine, it’s a shame future generations of the Johnson family and their philanthropic interests will not be financed to the extent they might have been if the assets had been more prudently diversified.

**More Fraud**

Reuters reported on May 27 that Kenneth Starr, a New York attorney and advisor to celebrities such as Martin Scorsese, Uma Thurman, and Annie Leibowitz was arrested on charges of running an investment fraud of as much as $30 million. It’s alleged that he spent some of the money on a new home worth $7.5 million. This is not the Kenneth Starr of Clinton/Lewinsky fame.