TAM ASSET MANAGEMENT REVIEW

Modern Investment Principles For Serious Investors

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Every client of TAM Asset Management receives a copy of Charles D. Ellis' book *Investment Policy*. This book is one of the most useful, objective, and contemporary sources on prudent investment strategy. It is also less than 100 pages long and very easy to read.

Mr. Ellis is managing partner of Greenwich Associates, the leading consulting firm specializing in financial services worldwide. The author of six books and dozens of articles, he has taught courses at both Yale and Harvard. Ellis earned his B.A. at Yale, an M.B.A. (with distinction) at Harvard and the Ph.D. at New York University.

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Asset Class Returns*

Through January 31, 1995

	YTD 1995
United States	
1-Yr. Bonds	+0.9%
5-Yr. Bonds	+1.1%
Large Stocks	+2.6%
Large Value Stocks	+2.3%
Small Stocks	+2.8%
Small Value Stocks	+1.0%
International	
Large Stocks	-3.7%
Large Value Stocks	-4.0%
Japan	
Small Stocks	-3.4%
Continental Europe	
Small Stocks	-0.7%
United Kingdom	
Small Stocks	-0.3%
Pacific Rim	
Small Stocks	-10.7%
Emerging Markets	
Large Stocks	-9.3%

The international markets are suffering in varying degrees from a bout of xenophobia due to the collapse of the Mexican peso.

*See "Performance Notes" on back page for explanations.

Managing Managers

Investment Policy: How to Win the Loser's Game

By Charles D. Ellis (Part 14 of 15)

Very few investment managers and very few clients are well satisfied with their present relationships. And it's their own fault. Too little attention is devoted by either clients or managers to designing and developing truly successful relationships. While investment managers can readily be faulted for not taking more initiative in this area, the primary responsibility does and always will rest with the clients.

Great clients make great firms, and clients of investment managers can do real service for their managers by combining three attributes: rigorous insistence on adherence to the explicitly agreed-upon mission; candor in discussing areas of dissatisfaction or uncertainty; and patience with the understandably emotional nature of investment managers—encouraging the glum and disappointed, cautioning the euphoric and self-assured.

Clients should assert themselves in developing good working relationships with investment managers for several reasons. First, as discussed in Chapter 1, clients know (or certainly ought to know) what is unusual and important about their investment objectives. And it is the client's responsibility to project this knowledge into the process of formulating long-term objectives and investment policy.

Second, investment managers are so deeply immersed in the demanding details of daily investment operations that it is implausible that they would—alone and unaided—find time and interest to think through the specific circumstances of each client and develop sensitively separate policies for each.

Third, the real need in most investment relationships is not for more *investment* management, but for more *management* management, and

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TAM Portfolio Returns Net of Fees*

Through January 31, 1995

Risk (% stocks)		Year-to-Date 1995	1994	1993	Since Inception 12/92-1/95
Aggressive	(95%)	-1.3%	+5.3%	+21.1%	+25.9%
Growth	(85%)	-0.6%	+2.6%	+16.6%	+18.7%
Moderate	(65%)	-0.2%	+2.1%	+14.0%	+16.1%
Benchmarks					
Balanced Fund Index		+1.2%	-2.2%	+11.7%	+10.6%
Capital Apprec. Index		+0.6%	-2.5%	+14.8%	+12.6%
S&P 500 Stock Index		+2.7%	+1.3%	+10.1%	+14.5%
Salomon Broad Bond Index		+2.1%	-2.8%	+9.9%	+9.0%

*See "Performance Notes" on back page for explanations.

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this set of skills is far more likely to be found among corporate executives, foundation trustees, and makers of trusts with general management experience and orientation than among investment management specialists.

Finally, it is the client who has the most to gain from developing successful and purposeful relationships. While the manager can lose the account, his downside risk is the loss of a fee; the client's downside risk is no less than the health of his whole portfolio.

Here are some suggestions on how to be a good client. First, start by knowing yourself and your organization and what your investment objectives and staying power really are. Your capacity to tolerate investment adversity needs examination in different time frames. For example, it's one thing to know your ability to handle what might be called quarter-to-quarter fluctuations. They are relatively modest and soon reversed. It's another to absorb and accept a full bear market, particularly one that lasts longer and plummets more than normal.

The perspective within which to test yourself is not from the calm armchair of the market historian who can see "how it all worked out." Instead, you'll want to think very carefully about the way you would feel and might react to the dreadful experience of a severe bear market at its worst moment, when the next stage is not known and may be even worse! This kind of candid self-critique will help you determine your true investment staying power.

Determining your tolerance for pain and your investment staying power will provide you with the basis upon which you can set the level of market risk that you can and will live with. Don't overcommit. Know your internal realities, and stay within your own limitations. As my father, Raymond W. Ellis advised: "Never risk more than you know you can afford to lose."

Second, learn to understand the *external* realities of the investment markets and do not expect more of your managers than they will be able to deliver. If you insist on "beat the market" performance, you *will* find managers who will make the promise. But can they keep it?

Third, select managers who are clearly competent to complete the mission you have in mind for them, who understand the mission and accept it, and with whom you would genuinely enjoy working.

Finally, strive always to discipline yourself to keep faith with your own commitment to a steady, long-term program. Try to follow the advice of Caesar: *De minimus non curat praetor!* (Don't be concerned with small matters!)

The main features of mutually advantageous manager-client relationships are not difficult to describe. First, the relationship should be designed and intended to last a long time. Changing managers is costly and disruptive for both manager and client, and usually comes only after an unhappy series of misunderstandings and mistakes leads to endemic mistrust.

As in any good business relationship, the responsibilities and undertakings of each party should be both realistic and clear. In particular, the investment manager's "mission" should be both explicit and in writing, and mutually agreed upon. It should be within the competence of the investment manager; it should be realistic and reasonable relative to the market; and it should be sufficient to satisfy the client's legitimate and informed expectations. If these three criteria are *not* being met, the client should get together with the investment manager until they have agreed on a mission statement that does meet all three tests.

Second, the relationship will usually be centered on quarterly or semiannual meetings, organized to achieve the success in working together desired by both investment manager and client. Before each meeting, an agenda should be prepared by the client and all relevant documentation should be provided, usually by the manager, with ample time for careful preparation by both manager and client. (The emphasis on *relevant* documentation is deliberate: It takes little genius to flood a meeting with sufficient trivia to camouflage the central issues.)

Each meeting should begin with a careful review of the investment manager's mission—the agreed-upon investment policies of the portfolio through which the manager is expected to accomplish the mutually intended long-term objective—to see if any modification in either objective or policy is appropriate. If they have no changes in mission to propose, both client and investment manager should explicitly reaffirm the mission statement. If either client or manager wishes to propose a change, the proposal and the rationale supporting it should be prepared in advance and distributed as one of the meeting preparation documents so all participants can study and think through the proposed change. There should, of course, be no surprises in this most important part of the meeting.

Discussion of specific portfolio operations—purchases and sales of specific securities—should be on an exception basis and should be brief. This portion of the meeting should *not* be "interesting." Clients should not accept colorful recitations of war stories or capsule reviews of specific stocks: They are fun, but they are only entertainment. Instead, this part of the meeting should be a straightforward confirmation that the manager has sensibly and faithfully followed agreed-upon policy. Like a successful medical examination, the review of operations should be thorough, expeditious, and conclude with the assurance, "as expected, everything is fine."

At most, the review of operations and reaffirmation of the investment manager's mission should take half an hour. The balance of the meeting time, usually another half hour, can best be devoted to a thoughtful and detailed discussion of almost any one topic of importance to both the client and the manager.

At least once each year, the topic should be a candid review— led by the client—of the client's overall financial situation and the context into which the investment portfolio fits.

Similarly, it will usually be relevant for the investment manager to devote one meeting to a discussion of his

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organization's professional and business development—with particular emphasis on the investment management firm's long-term business and professional policies and commitments—and the importance to his firm of the kind of account represented by the client.

Other meetings can constructively be devoted to discussions of a major economic development, a major portfolio commitment, or discussion of the changing economics or investment attraction of a particular industry. The important purpose of these topical discussions is to enable the client to take a deep look into the thinking process of the investment managers.

Meetings should *not* be used as they usually are for a brief Cook's tour of the investment world that might include superficial comments on the economic outlook, recent changes in interest rates, a review of minor changes in the weightings of industry groups in the equity portfolio, a quick recap of modest shifts in quality ratings in the bond portfolio, and concluding with some interesting insights into specific decisions.

Such discussions can easily deteriorate into a superficial "show and tell" report of current events. Without really digging into any of the major decisions made, they can use up the time that might other wise be devoted to serious discussions of subjects of potentially enduring importance to a successful relationship—and to the portfolio.

A written summary (of perhaps three to five pages) should be prepared and distributed after each meeting and kept for future reference. One good suggestion would be to have alternating meetings summarized by the clients and investment managers. Meetings should not be used to bring new members of the client's investment committee up-to-date. Such catch-up briefings should be conducted separately, perhaps earlier on the same day as the main meeting. With a good written record of each prior meeting, these catch-up briefings can be accomplished both quickly and reliably—to everyone's benefit.

Three functions can be served by an investment committee, and experience suggests they can be served best when carefully *separated.* The three functions are:

1. Determining *investment policy* for the whole fund over the very long term—focusing on long-term asset mix, riskiness, and so forth, and making careful, documented, and explicit judgments about what's "right" for the particular fund and feasible for long-term investment in the capital markets.

2. Dividing the total portfolio's overall investment policy into specific assignments for specific managers so each manager will have agreed-upon defined benchmarks or "normal" portfolios—with agreed-upon expectations for investment results in various market scenarios.

3. Evaluating the period-to-period effectiveness with which each investment manager is performing in meeting that manager's specific assignment.

The meeting's agenda for decisions to be made would match *each* of these three functions:

1. Is the asset mix "right" for this particular fund *and* feasible over the very long term? (Or to put it the other way around, is there a compelling near-term reason to change the previously "right" long-term policy to a *new* "right" long-term policy?)

Since changes in a pension plan's or an endowment's needs or even in an individual's situation or changes in the basic nature of the capital markets will develop only gradually, decisions to change investment policy seldom will be made.

They *might* be given careful review once a year; they should be reviewed carefully after any *major* change in the needs of the institution.

2. Given the overall investment policy—after making any sound, long-term adjustment—would it make sense to make any changes in the assignments given specific managers?

Again, change is unlikely and would be infrequent.

3. Given their performance relative to agreed-upon benchmarks *or* changes in the committee's assessment of each manager's capabilities to perform its mission, are any changes in managers called for?

Again, such changes are unlikely to be made. And experience shows that the best decision would be the "counterintuitive" decision: Assign *more* money to the manager who has been recently "*under*performing"—because the well-chosen manager will probably be "underperforming" only because his or her style is temporarily out of favor—and will likely outperform when market conditions are more favorable to his or her style.

If this three-tier approach were taken, the reports from consultants or staff to the investment committee would match these tiers, but in *reverse* order:

• Should any managers be changed? The normal expectation would be "No." If any manager is identified as "up for review," the staff or consultant would provide a rigorous review of the cases for and against action. (Note that "bad performance" is *any* substantial deviation from expectation, whether above or below the realistic and agreed-upon expectation.) If none are identified, discussion would be concentrated on . . .

• Should the amounts assigned to specific managers be changed? (For example, shifting assets *from* managers who have had quite favorable environments for their type of investing to managers whose style of investing has been "difficult.") If such actions *are* proposed (and such proposals for action would be infrequent), staff or consultants would provide the cases for and against each specific action. If none are proposed, discussion would concentrate on . . .

• Should the long-term policy on asset mix be changed? If not, would a significant "temporary" deviation be appropriate? If not, the work of the committee is over.

In this format, decisions would be on an "exception" basis and decisions to act would be few and far between *because* the investment committee had "done its homework" on long-term policy (and would rarely find a need to change) *and* on determination of specific missions for managers (and so would rarely seek a change) *and* on specific managers (and so would

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make few, if any, changes).

How long would an ideal meeting on action decisions take? About five minutes—with *no* actions taken because none were needed.

The most important contribution clients can make to a successful relationship with an investment manager is to select the right manager to begin with. Of course, the first step in selecting the right manager is to know what investment mission the chosen manager will be expected to fulfill.

Prospective investment managers should be examined in three major areas: professional investment competence; commitment to client service; and soundness of business strategy. Of the three areas, professional investment competence is quite properly given the greatest attention.

A prospective investment management firm should have a clear concept of how it will add value to managing the client's portfolio. Such a concept can be based on the manager's perception of an opportunity— or a problem—in the market that presents favorable opportunities for this particular firm to increase the portfolio's rate of return.

In addition to a cogent concept of how to add value, the investment manager should have developed a sensible process for making decisions to *implement* that concept and should have a valid record of achievement of the results intended.

Keep notes on the answers your investment manager gives to your questions. They can be brief but must be saved for future use—in comparing the answers you get at other times to the same or similar questions. This simple technique has been used for years—perhaps even for centuries—by the managers of the Scottish trusts.

The concept of using multiple managers has become increasingly popular among large clients in recent years. Several reasons are given:

1. The fund can select specialist managers skilled in each of several different kinds of investing wanted.

2. The fund can diversify against the risk of one manager's investment concept being out of tune with the overall market (as will surely happen from time to time).

3. Managers who fail to perform can be terminated more easily when they manage only part of the fund.

The problem with multiple managers is that the positive reasons become increasingly ephemeral as the number of managers increases. While it may be feasible to select one or two superior managers in a particular specialty, it's harder and harder to pick three or five or seven. There just aren't that many truly superior managers around.

While diversification does increase with each additional manager, when the separately managed portfolios are amalgamated into one fund and analyzed, it becomes clear that each additional manager adds less and less incremental diversification, but does incur higher and higher operating costs and fees, and moves closer and closer to the investment characteristics of the market fund.

Since market funds are readily available at low cost, the use of more and more different managers cannot be to reduce risk, because that can be accomplished more easily and more cheaply with a market fund.

Rationally, if the client is prepared to pay the higher fees inherent in multiple management, the objective must be to increase returns by finding managers who can find and exploit the occasional but significant opportunities that might arise from mispricing errors of other managers.

Realistically, important opportunities of this kind are only infrequently found. Therefore, the client might well force the manager to place all his bets on a very small number of decisions he believes are most attractive. If this forcing is not done, the client with multiple managers will most certainly be overpaying for excess diversification.

The argument that managers can be more easily terminated—with less harm to the fund and less harm to the management firm—if the account is relatively small to both parties is, of course, true. But it may be pernicious.

Clients might understandably be less careful in selecting or supervising managers they know they can terminate. And managers may be too cautious in asserting their best investment judgment if these clients might, during an interim period of adverse "performance," terminate them. Most investment managers believe, rightly or wrongly, that the tolerance of their clients for performance that differs significantly from the market and for portfolio decisions that differ from the conventional is least when needed most.

Consequently, unless guided by clearly defined investment objectives and policies, investment managers may be tempted to act as though their real goal is not to maximize investment results for their clients, but to maximize their probability of keeping the account. This could and does result in most portfolios being stuck in the "muddle of the middle," producing a high-cost but imperfect market portfolio.

Good clients will, if they decide to use active managers, insist that their managers adhere to the discipline of following through on agreed-upon investment policy.

Performance Notes:
Asset Class Returns—United States: 1-Yr. Bonds = DFA One-Year Fixed Income Portfolio; 5-Yr. Bonds = DFA Five-Year Government Portfolio; Large Stocks = Vanguard 500 Index Fund; Large Value Stocks = DFA Large Cap Value Portfolio; Small Stocks = DFA 9-10 Small Company Portfolio; Small Value Stocks = DFA Small Cap Value Portfolio. International: Large Stocks = 57% Vanguard Pacific Index Fund, 43% Vanguard Europe Index Fund (approximates the return of the Morgan Stanley EAFE Index); Large Value Stocks = Int'l Value Portfolio. Japan: Small Stocks = DFA Japanese Small Company Portfolio. Continental Europe: Small Stocks = DFA Continental Small Company Portfolio. United Kingdom: Small Stocks = DFA United Kingdom Small Company Portfolio. Pacific Rim: Small Stocks = DFA Pacific Rim Small Company Portfolio. Emerging Markets: Large Stocks = DFA Emerging Markets Portfolio **TAM Portfolio Returns Net of Fees**—These are the actual returns of TAM portfolios in each risk category net of actual TAM management fees, custodial fees, and fund expenses. The "Growth" returns were calculated using a model portfolio from 12/31/92 to 4/30/93. The "Aggressive" returns were calculated using a model portfolio from 12/31/92 to 3/31/93. In both cases, the maximum TAM fee was deducted, representative custodial costs were deducted, and all mutual fund returns are net of expenses. Past performance is no guarantee of future returns. This is especially the case with model portfolios which are not subject to specific economic or market factors. **Benchmarks**—Balanced Fund & Capital Appreciation Fund Indexes: Lipper Analytical's indexes representing the 30 largest balanced mutual funds and 30 largest capital appreciation mutual funds in the country.