TAM Asset Management Review

Modern Investment Principles For Serious Investors

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Beating The Market

Investment Policy: How to Win the Loser's Game, by Charles D. Ellis (Part 4 of 14)

The only way to beat the market, after adjusting for market risk, is to discover and exploit other investors' mistakes.

> Every client of TAM Asset Management receives a copy of Charles D. Ellis' book *Investment Policy*. This book is by far the most useful, objective, and contemporary source on prudent investment strategy I have seen in fifteen years of studying the subject. 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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>
> Jeff Troutner, TAM Asset Management

It can be done. And it has been done by most investors some of the time. But very few investors have been able to outsmart and outmaneuver other investors enough to beat the market consistently over the long term.

Active investment managers can work on any or all of four investment vectors:

1. Market timing.
2. Selection of specific stocks or groups of stocks.
3. Changes in portfolio structure or strategy.
4. An insightful, long-term investment concept or philosophy.

Even the most casual observer of markets and securities will be impressed by the simply splendid array of apparent opportunities to do better than "settle for average." The price charts for the overall market, for major industry groups, and for individual stocks make it seem obvious that active investors can and should do better.

MARKET TIMING

The most audacious way to increase potential returns is market timing. The classic market timer moves the portfolio in and out of the market so it is, he hopes, fully invested during rising markets and out of the market when prices are falling. Another form of timing would shift an equity portfolio out of stock groups that are expected to underperform the market and into groups that may outperform the market.

In a bond portfolio the market timer hopes to shift into long maturities before falling interest rates drive up long bond prices and back into short maturities before rising interest rates drive long bond prices down.

In a balanced portfolio the market timer strives to invest more heavily into stocks when they will produce

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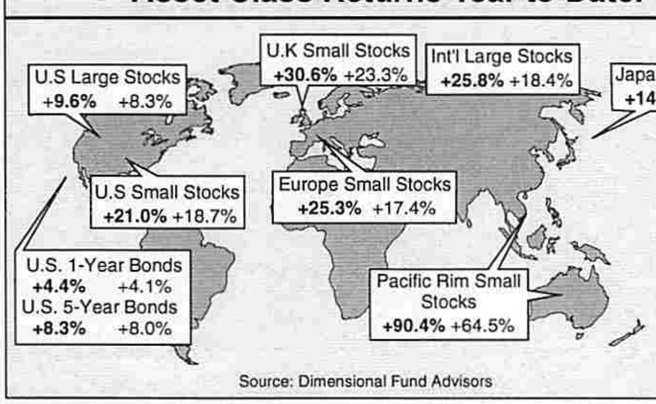
Asset Class Returns Year-to-Date: 12/31/93



Change This Month:
All of the markets, including Japanese Small Stocks, finished the year higher on the heels of a strong December. The Pacific Rim Small Stocks continued their strong move to new highs.

This Month Last Month

TAM Account Performance

Risk Level		1993
Moderate	(65% stocks)	14.0%
Growth[1]	(85% stocks)	16.6%
Aggressive[2]	(95% stocks)	21.1%

[1]Simulated returns from 12/31/92 to 3/31/93
[2]Simulated returns from 12/31/92 to 7/31/93

Past returns not necessarily indicative of future results.

Returns are net of all fees.

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greater total returns than bonds, then shift into bonds when they will produce greater total returns than equities, and into short-term investments when they can produce greater total returns than either bonds or stocks.

A delightful comparative analysis of two kinds of investment perfection for the period 1940-73 gives a sense of the seductive "potential" of market timing. The first record was the result of perfect market timing with 100 percent in equities in all rising markets and 100 percent in cash in all falling markets.

"One careful study of market timing concluded that an investment manager would have to be right on his market forecast 75 percent of the time for his portfolio just to break even after measuring the costs of mistakes and the costs of transactions."

With 22 transactions (11 buys and 11 sells) in 34 years, and using the Dow Jones Industrial Average as a proxy for equities, $1,000 was expanded into $85,937.

During the same 34-year period, with the hypothetical portfolio always 100 percent invested and always invested in the one best industry group, the same $1,000 (with 28 buys and 28 sells) exploded into $4,357,000,000! The last two years indicate the pluck requisite to the process: In January 1971, $687 million was invested in restaurant companies and became $1.7 billion by year end, and was then committed to gold stocks which carried it up to $4.4 billion by Christmas! Of course this example is absurd. It has never been done and never will be done. More importantly, even far less magical results have not and will not be achieved through "timing" because no one manager is so much more astute than his or her competitors.

Despite the enticing appeal of reducing market exposure by astute sales when securities appear to be overpriced, and boldly reinvesting when prices appear to have declined to attractive low levels—selling high and buying low—the overwhelming evidence shows that market timing is not an effective way to increase returns for one dour but compelling reason: on average and over time, it *does not work.*

The evidence on investment managers' success with market timing is impressive—and overwhelmingly negative. One careful study of market timing concluded that an investment manager would have to be right on his market forecast 75 percent of the time for his portfolio just to *break even* after measuring the costs of mistakes and the costs of transactions. Robert Jeffrey has explained why it is so difficult to improve results with market timing: so much of the "action" occurs in such brief periods and at times when investors are most likely to be captives of a conventional consensus. An unpublished study of 100 large pension funds and their experience with market timing found that while all the funds had engaged in at least some market timing, not one of the funds had improved its rate of return as a result of its efforts at timing. In fact, 89 of the 100 lost as a result of "timing"—and their losses averaged a daunting 4.5 percent over the five-year period.

Just as there are *old* pilots, and there are *bold* pilots, but there are no old bold pilots, there are *no* investors who have achieved recurring successes in market timing. Decisions that are driven by either greed or fear are usually wrong, usually late, and very unlikely to be reversed correctly. Particularly with real money, don't even *consider* trying to outguess the market or outmaneuver the professionals to "sell high" and to "buy low." You'll fail, perhaps disastrously.

As Fischer Black put it, "The market does just as well, on average, when the investor is *out* of the market as it does when he is *in*. So he loses money, relative to a simple buy-and-hold strategy, by being out of the market part of the time."

Perhaps the best insight into the difficulties in market timing came from an experienced professional's candid lament: "I've seen lots of interesting approaches to market timing—and I have tried most of them in my 40 years of investing. They may have been great before my time, but not one of them worked for me. Not one!"

The case for *not* attempting market timing is partly that the history of many, many investment managers shows that the market does as well when they are heavily in cash as it does when they are fully invested—and vice versa. (In fact, professional investment managers usually cancel each other out with the number who are increasing cash in each period equal to the number who are reducing cash during the same period.)

The second reason is even more striking. Figure 2-1 shows what happens to long-term compound returns when the best days are removed from the record. Taking out the 10 best days—

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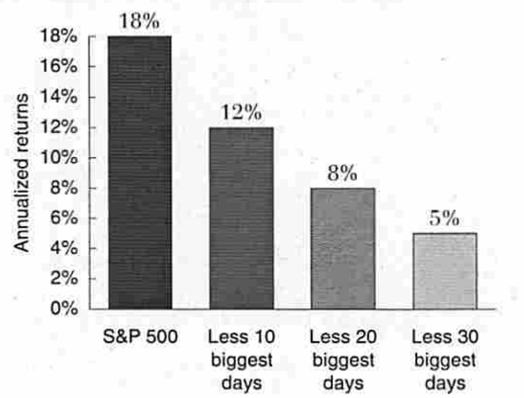
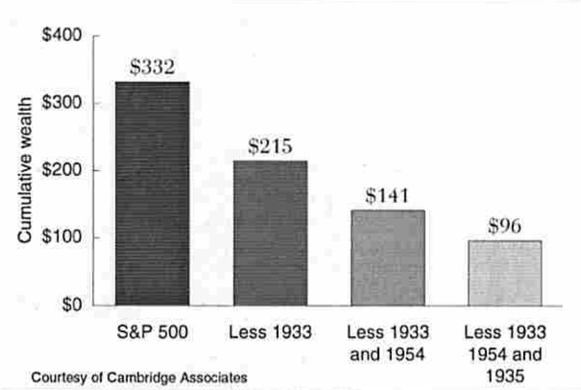
Figure 2-1
Compound Returns (%) 1982 through 1990



Courtesy of Cambridge Associates

less than 1/2 of 1 percent of the period examined—cuts the average rate of return by one third from 18 percent to 12 percent. Taking the 10 next best days away cuts returns almost another one third to 8.3 percent. Removing a total of 20 days—1 1/2 percent of the total period—cuts returns from 18 percent to 5 percent. Figure 2-2 shows a similar result when the best *years* are excluded from the calculation of the long-term averages. The lesson is clear: You have to be there "when lightening strikes."

Figure 2-2
Cumulative Returns ($) One Dollar Invested 1928 through 1990



Courtesy of Cambridge Associates

There is no evidence of any large institutions having anything like consistent ability to get in when the market is low and get out when the market is high. Attempts to switch between stocks and bonds, or between stock and cash, in anticipation of market moves, have been unsuccessful much more often than they have been successful.

STOCK SELECTION

The second tactical way to increase returns is through stock selection or "stock picking." Professional investors devote an extraordinary amount of skill, time, and effort to this work. Stock pricing dominates the research efforts of investing institutions and the research services of stock brokers.

Through financial analysis or field studies of competitors and suppliers as well as management interviews, investors seek to attain a better understanding of the investment value of a security or group of securities than the market consensus. When investment managers find significant differences between the price and the value of a security (as they appraise it), they can buy or sell, as appropriate, to capture the differential between the market's price and the true investment value for their clients' portfolios.

Unfortunately, however, security analysis does not appear to be a useful or profitable activity. The stock investment managers sell after doing fundamental research, and the stocks they don't buy, typically do as well as the stocks they do buy.

Again, the problem is not that investment research is not done well. The problem is that it is done so very well by so many that no one group of investors is likely to gain a regular useful advantage over all other investors.

PORTFOLIO STRATEGY

Strategic decisions—in both stock and bond portfolios—involve major commitments that affect the overall structure of the portfolio. They are made to exploit insights into major industry groups or changes in the economy and interest rates or anticipated shifts in the valuation of major types of stocks such as "emerging growth" stocks or "basic industry" stocks. Each of these judgments would involve what can be described as market segment risk.

For example, in 1980 portfolio managers who invested heavily in two areas—oil and technology—had very favorable results compared to investors who chose instead to invest heavily in utilities and other interest-sensitive stocks or in consumer stocks. Equally important, they had to be out of energy stocks in 1981 or they would "give it all back."

"With so many apparent opportunities to do better than the market, it must be disconcerting for investment managers—and their clients— to see how hard it is for investment managers, in fact, to do better than the market after adjustment for risk over the long haul."

In the early 1970s, portfolio managers who invested heavily in large capitalization growth stocks—the "nifty 50"—experienced exceptionally favorable results as the notorious "two tier" market developed.[1] In the later 1970s, large positions in these same securities produced exceptionally negative market results when previously anticipated earnings failed to materialize and institutions became disenchanted with the concept and dumped their holdings, which collapsed the price/earnings (P/E) ratios and brought stock prices way down. The same sort of thing happened with small high-tech stocks in the 1980s, appreciating far faster than the market from 1980 to 1983 and then falling much faster than the market in 1984. In the late 1980s and in 1990, "value" stocks (which had outperformed the market for a decade) plunged, reversing large parts of the prior 10 years' gains.

As the well-worn saying goes, it is not a stock market but a market of stocks—one that invites portfolio managers (but not without peril) to make major strategic decisions on groups of stocks in the portfolios they manage.

Full of interesting potential—being in the right place at the right time—

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[1]Growth stocks had a much higher P/E ratio than industrial stocks, dividing the market into two tiers.

this approach to investing challenges the manager to discover the new (and often unfamiliar) way to invest as markets shift, become proficient at each new way, and then abandon it for another new way. Of course, it can be done, but will it be done? By which managers? For how long?

INVESTMENT PHILOSOPHY

The fourth possible means to increase returns is to develop a profound and valid insight into the forces that drive a particular sector of the market or a particular group of companies or industries and systematically exploit that investment insight or concept.

Investing to exploit an investment concept or philosophy involves an enduring investment commitment—through cycle after cycle in the stock market and in the business economy—for an individual portfolio manager or an entire investment management organization.

An organization that is committed, for example, to growth stock investing will concentrate on evaluating new technologies, understanding the management skills required to lead rapidly growing organizations, and analyzing the financial requirements of investing in new markets and new products to sustain growth. This investment organization will, it is hoped, learn from experience—no doubt sometimes painful experience—how to discriminate between ersatz "growth stocks" that fizzle out and true growth companies that will achieve success over many years.

Other investment management organizations take the view that among the many large corporations in mature and often cyclical industries, there are always some that have considerably greater investment value than is recognized by other investors; that with an astute research capability these superior values can be isolated; and that by buying good values at depressed prices they can achieve superior returns for their clients with relatively low risk. Such organizations will develop considerable expertise in "separating the wheat from the chaff," avoiding the low-priced stocks that *ought* to be low priced, and ferreting out insights into investment value that other investors have not yet recognized.

Among the variety of different concepts of investing that can be pursued over many, many years, one emphasizes medium-sized growth companies in specialized industries while another focuses on assets rather than earnings with confidence that carefully chosen, well positioned assets can and will some day be redeployed to earn good profits. Another group of "contrary opinion" investors will concentrate on stocks that are clearly out of favor with most investors, confident that by looking where prices are depressed, and analyzing many companies dispassionately, they will find bargains.

"All four of these basic forms of active investing have one fundamental characteristic in common: <u>They depend on the errors of others.</u>"

The important test of an investment concept or philosophy is the manager's ability to adhere to it for valid, long-term reasons—even when the short-term results are most disagreeable and disheartening. Persistence can lead to mastery and development of an important distinctive competence in the particular kind of investing in which the manager specializes.

The great advantage to the conceptual or philosophical approach is that the investment firm can organize itself to do its own particular kind of investing all the time, avoid the noise and confusion of alternatives, attract investment analysts and managers interested in and skilled at the particular type of investing, and through continuous practice, self-critique, and study to master it. The great disadvantage is that if the chosen kind of investing becomes obsolete or out of touch with the changing market, a proficient specialist organization is most unlikely to detect the need for change until it is too late.

What is remarkable about these profound investment concepts is how few have been discovered that last for very long—most likely because the hallmark of a free capital market is that few if any opportunities to establish a proprietary long-term competitive advantage can be found and maintained for a long time.

All four of these basic forms of active investing have one fundamental characteristic in common: *They depend on the errors of others.* Whether by omission or commission, the only way in which a profit opportunity can be available to the active investor—in an individual stock or a group of stocks—is that the consensus of other investors is *wrong*.

With so many competitors seeking superior insight into the value/price relationship of individual stocks or industry groups, and with so much information so widely and rapidly communicated throughout the investment community, the chances of discovering and exploiting profitable insights into individual stocks or groups of stocks—opportunities left behind by the errors and inattention of other investors—are certainly not richly promising.

With so many apparent opportunities to do better than the market, it must be disconcerting for investment managers—and their clients— to see how hard it is for investment managers, in fact, to do better than the market after adjustment for risk[2] over the long haul. Yet, even the most talented investment manager must wonder how he can expect his hardworking and determined competitors to provide him—through incompetence, error, or inattention—with sufficiently attractive opportunities to buy or sell in size on significantly advantageous terms on a regular basis so he can "beat the market."

[2]See Chapter 1 for an explanation.