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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Why Policy Matters

Investment Policy: How to Win the Loser's Game

By Charles D. Ellis (Part 11 of 14)

The principle reason for articulating long-term policy explicitly and *in writing* is to enable the client and portfolio manager to protect the portfolio from ad hoc revisions of sound long-term policy, and to help them hold to long-term policy when short-term exigencies are most distressing and the policy is most in doubt.

History teaches that both investment managers and clients need help if they are to hold successfully to the discipline of long-term commitments. This means restraining themselves from reacting inappropriately to disconcerting short-term data and keeping themselves from taking those unwise actions that seem so "obvious" and urgent to optimists at market highs and to pessimists at market lows. The best shield for long-term policies against the outrageous attacks of acute short-term data and distress are knowledge and understanding committed to writing.

The misdemeanors of investment management are almost all due to an inadequate advance understanding by a client or portfolio manager (or both) of either the *internal* realm of client objectives or the *external* realm of capital markets and investment, or both. If a major decision is truly fiduciary in nature, it never needs to be done quickly. Time urgent decisions are *never* fiduciary.

All too often, investment policy is both vague and implicit, left to be "resolved" only in haste, when unusually distressing market conditions are putting the pressure on and when it is all too easy to make the wrong decision at the wrong time for the wrong reasons.

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Asset Class Returns*
Through September 30, 1994

	YTD 1994
United States	
1-Yr. Bonds	+1.9%
5-Yr. Bonds	-2.7%
Large Stocks	+1.2%
Large Value Stocks	-3.0%
Small Stocks	+5.3%
Small Value Stocks	+5.3%
International	
Large Stocks	+9.6%
Japan	
Small Stocks	+33.0%
Continental Europe	
Small Stocks	+15.4%
United Kingdom	
Small Stocks	+8.5%
Pacific Rim	
Small Stocks	-4.1%

September was generally a down month for the markets. The Pacific Rim and U.S. small stocks made slight gains, but for the most part the highs in the markets were hit at the end of August. For the first three quarters of the year, the broad diversification of the TAM portfolios has served clients well.

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

TAM Portfolio Returns Net of Fees*
Through September 30, 1994

Risk (% stocks)	Year-to-Date 1994	1993	Since Inception 12/92-9/94
Aggressive (95%)	+9.3%	+21.1%	+32.4%
Growth (85%)	+5.7%	+16.6%	+23.0%
Moderate (65%)	+4.3%	+14.0%	+18.9%
Benchmarks Comparisons			
Balanced Fund Index	-1.0%	+11.7%	+10.5%
Capital Apprec. Index	-1.1%	+14.8%	+13.6%
S&P 500 Stock Index	+1.3%	+10.1%	+11.5%
Salomon Broad Bond Index	-3.2%	+9.9%	+6.4%

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

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Such improvisational reviews typically result in a substantial shift from equities at temporarily depressed prices into bonds and other fixed-income investments that will not rise in capital value with the next cycle of the equity market, and vice versa. Clearly, such ill-timed changes in asset mix—selling low and buying high—can be very harmful to the long-term returns of the portfolio.

Comparable harm is also done when recent returns have been higher than should be expected, and investment managers and their clients shed requisite caution and boldly increase the amount of market risk in the portfolio. This extra portfolio risk may soon magnify the impact of a subsequent market decline, exacerbate the normal investor anxieties, and lead to another of those ad hoc policy revisions that cause investors to "sell low" what they have previously "bought high."

Investors are people and, like all other people, make decisions based on their emotions when cool, rational analysis would call for a very different action. Investors like best those market movements that are most *adverse* to their long-term interests, and most *dislike* market movements that are, in fact, in their long-term interests.

Yet, as much as we may be able to see that our long-term interests are best served by lower stock prices, who among us can honestly say we don't feel a warm glow of affection for stocks and markets that have gone up even though it means stocks are now more expensive to buy and future rates of return on our additional investments will be lower? But we are wrong when we feel good about stocks having gone up, and we are wrong when we feel bad about stocks having gone down.

This brings us back to the main reason for studying and understanding investment and markets: to protect our portfolios from ourselves. The problem, as Santayana so aptly put it, is that "those who do not study history are doomed to repeat it."

Psychologists studying anxiety and fear have found four characteristics make people more worried about the perceived riskiness of a situation than the realities would warrant: large-scale consequences; beyond personal control or influence; unfamiliarity; and sudden occurrences. As a result, we are more fearful of air travel (in which fewer than 30 people are killed and fewer than 350 hurt in a typical year) than of travel in cars (in which 30,000 people are killed yearly and 350,000 injured).

Most clients of professional investment managers experience great anxiety over large-scale, sudden, and frightening losses in portfolio value primarily because they have not been well informed in advance that these events are expected by those who have studied and understand the long history of stock markets.

Such drops in the market are eminently predictable—not in their timing, but in their magnitude and suddenness. And it is in these periods of anxiety—when the market has been most severely negative and policies appear most acutely in doubt—that clients and managers predictably engage in ad hoc "reappraisals" of long-term investment policy.

The situation is understandable. Clients are not sufficiently informed about the true nature of investment markets and do get surprised. And investment managers are literally overwhelmed by information in written reports; private and group meetings with corporate executives, economists, and analysts; telephone calls; stock price quotations; market transactions that give a compelling urgency to the here and now; and to what others are or may be thinking of doing.

The resulting excessive attention to the present and the immediate future not only produces the "groupthink" error brilliantly explored by Gustave LeBon in his great book, *The Crowd*, but also distracts attention from careful study of the profound difference in the short-run versus the long-run nature of investments.

Investment managers and their clients can do a lot to improve long-term portfolio returns by being sure that both are well informed about the realities of the investment environment in which the portfolio will be managed. Clients should ask their managers to review for them the rate of return and pattern of deviation away from the averages over the past decade or longer, explaining as carefully as possible why the markets moved as they did. Thoughtful, objective study of the past is the best (and also the least costly!) way to develop an understanding of the basic nature of investments and markets. Markets always have been and always will be surprising, but there is no justification for managers or clients being amazed or shaken by any market development.

Only with shared understanding of the nature of investing and capital markets will investment managers and their clients escape the present paradox in which little or no attention is devoted to the truly important work of developing and adhering to wise and appropriate investment policies that can, over time, achieve realistic and relevant investment objectives.

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; 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). 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.
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.