TAM ASSET MANAGEMENT REVIEW

Modern Investment Principles For Serious Investors

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The Paradox

Investment Policy: How to Win the Loser's Game, by Charles D. Ellis (Part 6 of 14)

A paradox is haunting investment management.

The paradox is that funds with very long-term purposes are being managed to meet short-term objectives that may be neither feasible nor important. And they are *not* being managed to achieve long-term objectives that are both feasible and worthwhile.

The unimportant and difficult task to which most investment managers devote most of their time with little or no success is trying to "beat the market." Realistically—without taking above-average market risk—to outperform the equity market by even one half of 1 percent *consistently* would be a great success which almost no sizable investment managers have achieved for very long.

The truly important but not very difficult task to which investment managers and their clients could and should devote themselves involves four steps: (1) understanding the client's needs, (2) defining realistic investment objectives that can meet the client's needs, (3) establishing the right asset mix for each particular portfolio, and (4) developing well-reasoned, sensible investment policies designed to achieve the client's realistic and specified long-term investment objectives. In this work, success can be easily achieved.

For example, if the long-term average rate of return on bonds is 8 percent, and the return from investments in common stocks is 16 percent—because there must be a higher long-term rate of return on stocks to convince investors to accept the risk of equity investing—then shifting just 5 percent of the portfolio's assets from bonds to stocks and keeping it there would, over time, increase the portfolio's average annual rate of return by 4/10 of 1 percent (8 percent x 5 percent = 0.40 percent).

Shifting the asset mix of a 60 percent equity/40 percent fixed-income portfolio to 65:35 is not a major proposition, but, as noted in the previous chapter, consistently beating the market rate of return by 40 basis points a year through superior stock selection would be a substantial achievement.

Very few institutional investors have been able to achieve and sustain such superior results.

It is ironic that a change of even such modest magnitude in the basic asset allocation decision can capture an improvement in total return significantly greater than the elusive increment sought in the beat-the-market syndrome.

Clearly, if the asset mix truly appropriate to the client's objectives justified an even more substantial emphasis on equities—such as 70:30, or 80:20, or 90:10, or even

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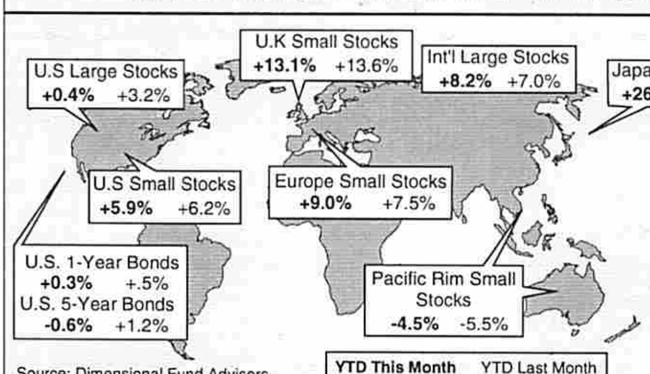
Every client of TAM Asset Management receives a copy of Charles D. Ellis' book *Investment Policy*. This book is by far the most useful, objective, and contemporary source on prudent investment strategy I have seen in fifteen years of studying the subject. It is also less than 100 pages long and very 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.

Jeff Troutner, TAM Asset Management

Asset Class Returns Year-to-Date: 2/28/94



Source: Dimensional Fund Advisors

Change This Month: With the exception of the Pacific Rim stocks, the international markets continue to provide higher returns than U.S. large & small company stocks. The U.S. markets appear to be undergoing a long-awaited correction, the depth of which remains to be seen.

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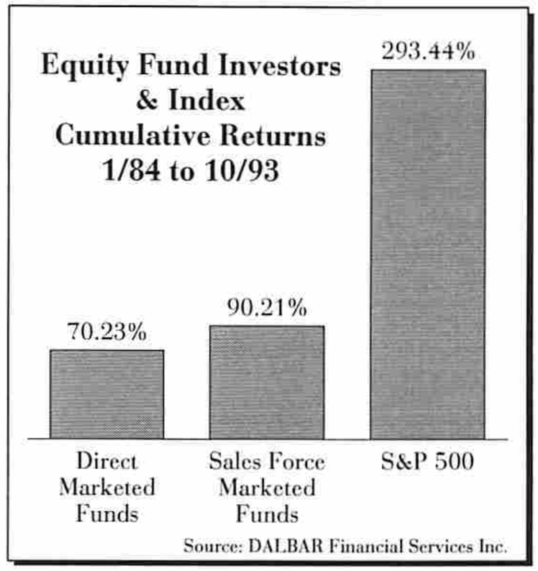
To flee, or not to flee? That is the question.

By Jeff Troutner



As I write this, the DJIA has dropped over 400 points from its high in January, a loss of over 10%. By the time this "correction" is over, many individual investors and money managers will have sold significant percentages of their stock holdings. They will further compound the effect of their move by waiting for stocks to move higher before jumping back in.

The risks of active management—stock picking and market timing based on "crystal ball" theories— have been well documented in past newsletters. We have also warned of the added risks (costs) of commission-based brokers and financial planners who encourage investors to switch in, out, and between active managers and mutual funds.

In explaining the most important service TAM offers to clients, we have also challenged the ability of investors and retirement plan fiduciaries to set long-term investment policies and *stick to them*. Most investors need the professional guidance of firms like TAM for no other reason then to keep them on the right course through thick and thin. It is almost impossible to fight off the constant onslaught of brokers, advisors, and others who see market downturns as a feeding frenzy, and plan sponsors, wealthy individuals, successful professionals and others as their next dinner guests.

Now, a recent study by DALBAL Financial Services, a Boston-based mutual fund research firm, quantifies investor behavior over the period January, 1984 through September, 1993. The study shows that do-it-yourselfers (those who purchased "direct marketed" no-load funds) failed miserably at staying with a long-term investment program. Broker-assisted investors (those who purchased "sales force marketed" load funds) did not fare much better. On the other hand, an investor who simply "bought the market" would have added almost 200% in extra return to their bottom line (see the above chart; an S&P 500 index fund returned 282.25% over the period).

The moral of this story is clear. The services we offer to clients, particularly the discipline to stay with a buy and hold strategy over the long-term, will serve our clients well in the face of an overwhelming urge to "flee" at times. Adding additional asset classes to the S&P 500 with index funds available only to advisors like TAM can also boost returns by a significant amount. Choosing *your* route requires a realistic self-evaluation *and* a serious review of the alternatives.

The Paradox (cont.)

100:0—the incremental rate of return over the 60:40 portfolio would be even greater: 0.8 percent annually at 70:30 increasing to 1.6 percent annually at 80:20 and 3.2 percent average annually at 100 percent. Virtually no large investment manager can hope to beat the market by such magnitudes.

Of course, these calculations are mechanical. They present averages ignoring the fact that actual returns in individual years come in an impressive, even intimidating, distribution around these averages.

The crucial question is not simply whether long-term returns on common stocks would exceed returns on bonds or bills if the investor held on through the many startling gyrations of the market.

The crucial question is whether the investor will, in fact, hold on. The problem is not in the market, but in ourselves, our perceptions, and our reactions to our perceptions. This is why it is so important for each client to develop a realistic knowledge of his own and/or his organization's tolerance for market fluctuations and his long-term investment objectives, and to develop a realistic understanding of investing and of capital markets. The more you know about yourself as an investor and the more you understand investment management and the securities markets, the more you will know what asset mix is really right for your portfolios, and the more likely you will be able to sustain your commitment for the long term. *(See the article above .)*

In investment management, the real opportunity to achieve superior results is not in scrambling to outperform the market, but in establishing *and adhering to* appropriate investment policies over the long term—policies that position the portfolio to benefit from riding with the main long-term forces in the market. Investment policy, wisely formulated by realistic and well-informed clients with a long-term perspective and clearly defined objectives, is the foundation upon which portfolios should be constructed and managed over time and through market cycles.

In reality, very few investors have developed such investment policies. And because they have not, most investment managers are left to manage their clients' portfolios without knowing their clients' real objectives and without the discipline of explicit

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agreement on their mission as investment managers. *This is the client's fault.*

As a result of not knowing enough about the particular facts and values of their different clients, investment managers typically manage all funds in virtually the same way and with very nearly the same asset mix, even in such extraordinarily different kinds of employee benefit funds as pension funds and profit sharing funds.

The profound differences between the functions and needs of pension plans and profit sharing plans make them striking examples of a disconcertingly standardized approach to the most important investment decision: the asset mix. So far as the total sum received by each individual is concerned, profit sharing plans terminate entirely on the day he or she retires or leaves; thus the fund has a series of absolute and predictable end points.

This risk of "end period dominance" calls for an investment policy that avoids major fluctuations in market value.[1] Pension plans, on the other hand, are virtually perpetual investment vehicles, funded to provide a stream of annuity payments to plan participants over a very long and highly predictable period; they can easily accept quite substantial market fluctuations during the long "interim" period.

That the investments of pension funds and profit sharing plans are not, in fact, differentiated on even such a powerful and basic dimension as the stock-bond ratio, leads to the sobering conclusion that while investment policy conforming to the client's particular investment objectives may be honored in theory, it is little used in practice.

The differences in employees benefit plans can be substantial, but these differences will only matter if corporate executives vigorously represent the special characteristics of their company and their plan when basic investment policies are being formulated or reviewed.

It is hardly conceivable that senior corporate management would routinely delegate full operating responsibility for comparable millions of dollars[2] to regular operating divisional executives—let alone a manager not directly supervised by top management—with only such broad guidelines or instructions as: "Try to do better than average," or "You're the experts, see what you can do for us."

The real question is not whether portfolio managers are constructing portfolios to match the goals and objectives of each specific client. (The uninspiring reality is that they do not.) The relevant question is: Who is responsible for bringing about the requisite change? The pragmatic answer is that the responsibility is not going to be fulfilled by investment managers. It will be left to the client. Clients can and should accept this responsibility.

Clients can do more for their portfolio's long-term rates of return by developing and sustaining wise long-range policies that commit the portfolio to an appropriate structure of investments than can be done by the most skillful manipulation of the individual holdings within the portfolio.

In brief, clients should subordinate portfolio operations to investment policy, and should assert their responsibility for leadership in policy formation. This is not an investment problem that should be left to portfolio managers—no matter how skilled and conscientious they are—any more than, as Clemenceau observed, war should be left to the generals. It is the client's problem, and while responsibility for it can be abdicated, it really cannot be delegated.

Only the client will know enough to speak with relevance and credibility to such important characteristics as the amount, timing, and certainty of flows *out* of the fund. Only the client knows his own or his organization's tolerance for changes in market prices—particularly at market extremes where it really matters—because it is at such stress periods when investment policies seem least certain and the pressure for change is most strong. For individual investors, only they will know their overall financial and investment situation—their earning power, their ability to save, their obligations for children's educational expenses, or how they feel about investments.

Corporate executives will know their pension plan's actuarial assumptions and how close to reality these assumptions really are; the company's tolerance for intrusions upon its quarter-to-quarter and year-to-year progression of reported earnings by a sudden need to fund a deficit in plan assets caused by an abrupt drop in market value of pension assets; the company's evolving philosophy of employee benefits and how benefit programs might be changed; the company's likelihood to increase benefits to retired plan participants to protect their purchasing power from the corrosion of inflation; and the tolerance of interim market fluctuations among staff, senior executives, and the board of directors. The "risk tolerance" of a corporate pension plan sponsor is not just the risk tolerance of the pension staff or even the senior financial officer: It is the risk tolerance of a majority of the board of directors at the moment of most severe market adversity.

Here are six important questions each client should think through, and then explain his own answers to the investment manager. (Investment managers would be wise to urge their clients to do this kind of "homework.")

First, what are the real risks of an adverse outcome, particularly in the short run? Unacceptable risks should never be taken. For example, it would not make sense to invest all of a high school senior's college tuition savings in the stock market because if the market went down, the student might not be able to pay the tuition bill. Nor

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[1] Profit sharing plans can easily be designed to minimize this problem. In more and more companies, each plan participant has a separate account in which the asset mix can be adapted to the risk preferences of the individual and can be changed over time to reflect the worker's changing circumstances: all in growth stocks when young, shifting to a conservative balanced portfolio towards retirement, and so forth.

[2] At some companies, pension fund assets are larger than the sponsoring corporation's net worth.

would it make sense to invest money saved for a house in stocks just two or three years before the intended date of purchase.

Second, what are the probable emotional reactions of clients to an adverse experience? As the axiom goes, some investors care about eating well and some care about *sleeping* well. The portfolio manager should know and stay well within the client's informed tolerance for interim fluctuations in portfolio value. The emphasis on *informed tolerance* is deliberate. Avoidance of market risk does have a real "opportunity cost," and the client should be fully informed of the opportunity cost of each level of market risk *not* taken.

Third, how knowledgeable about investments and markets is the client's investment committee? Investing does not always "make sense." Sometimes it seems almost perversely counterintuitive. Lack of knowledge tends to make investors too cautious during bear markets and too confident in bull markets—sometimes at considerable cost. Managers should be careful *not* to assume their clients will be more sophisticated than they really are.

Portfolio managers can help their clients by explaining the way capital markets behave—and misbehave—and clients can help educate themselves.

The client who is very well informed about the investment environment will know what to expect. This client will be able to take in stride those disruptive experiences that may cause other less informed investors to overreact to either unusually favorable or unusually adverse market experience.

Fourth, what other capital or income resources does the client have and how important is the particular portfolio to the client's *overall* financial position? For example, pension funds sponsored by large and prosperous corporations can reasonably accept greater market risk than can a college endowment, which may have difficulty raising capital to replenish losses. A retired widow usually cannot accept as much risk as can her alma mater.

Fifth, are any legal restrictions imposed on investment policy? Many endowment funds have restrictions that can be significant, particularly when they specify how income is to be defined or spent, or both.[3]

Sixth, are there any unanticipated consequences of interim fluctuations in portfolio value that might affect policy? A frequently cited example is the risk in a pension fund of being obliged to augment contributions if the portfolio's market value drops below a "trigger" level built into the actuaries' calculations of current contributions.[4]

Each of these possible concerns should be rigorously examined to ascertain how much deviation from the normally optimal investment policy—broad diversification at a moderately above-average market risk—is truly warranted. Understanding and using these insights into the specific realities of the particular client's situation and objectives is the basis upon which wise investment policies can be developed for each different portfolio.

In pursuing the goal of developing and using wise investment policies, we must first recognize that most *institutional* funds such as pensions and endowments are *un*owned money: They do not really "belong" to anyone. There is no individual who can or would say "This is my money. *This* is what I want you to do with it. Or else." There are, in other words, no principals.

Second, we should recognize that those who are "at the controls" are usually only representatives of an organization and subject to after-the-fact criticism by powerful Monday-morning quarterbacks. These representatives have clear economic incentives to protect their careers: "It may not be my money, but it is my job."

Third, the careers of these institutional representatives seldom hinge on the work they do in setting investment policy or managing investment managers. Most have other more important functions, and almost all will hold their present responsibilities for only a few years. They are *not* long-term players.

In such circumstances, what pattern of behavior would we expect of these representatives? Clearly they will be defensive in the "mini-max," and will make their decisions with reference to a relatively short time period, say three to five years. They will not seek to optimize, they will seek the most acceptable near-term balance between desires for superior returns and avoidance of unusual or unorthodox positions. And above all, they will avoid any unnecessarily distressing risk to their own careers!

What are investment managers doing? The very same thing. They want to keep their accounts. They are understandably cautious. They are compromising with a defensive tilt, seeking "not to lose" over a three-to-five year horizon.

Observers of the paradox that haunts investment management say it is unrealistic to expect investment managers to risk strained client relationships by insisting on a well-conceived and carefully articulated investment policy with explicit objectives when their clients seem uninterested in going through the discipline.

For that, we must look not to the agents but to the principals. But in institutional investment management there *are* no principals. And if there often are no agents willing to act like principals, then we can be sure that the paradox will remain for a long time.

Escape from the paradox depends on clients asserting their role as experts on their own needs and resources and

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[3] As William Carey and Craig Bright advocate in their fine study, The Law and the Lore of Endowment, restrictions should be carefully examined because they may not be as confining as they might initially appear.

[4] Actuarial calculations have an apparent precision that Fellows of the Society of Actuaries would be among the first to caution are based on estimates and judgments.