



## the consilient observer

applying cross-discipline frameworks to investing

con · sili · ence, n. [con- + salire to leap]  
 con · sili · ence, n. [con- + salire to leap]  
 interlocking explanations of cause and effect between disciplines  
 interlocking explanations of cause and effect between disciplines

# Investing: Profession or Business?

## Thoughts on Beating the Market Index

*I'm beginning to wonder how to persuade the businessperson who owns a large investment management organization that the first and essential priority is to protect the vital core: the classic disciplines of investing as a profession.*

Charles D. Ellis

*Will Business Success Spoil the Investment Management Profession?*<sup>1</sup>

*There seems to be some perverse human characteristic that likes to make easy things difficult. It's likely to continue that way. Ships will sail around the world but the Flat Earth Society will flourish.*

Warren Buffett

*The Superinvestors of Graham-and-Doddsville*<sup>2</sup>

### The Scouting Report

To prepare to win, most teams scout their competition. The objective is to create a game plan that exploits the competition's weaknesses and neutralizes its strengths. Teams generally consider intelligent scouting vital to their long-term success.

So what's the competition for a money manager? Investors with particular objectives can typically invest either with active managers or with index funds. For example, an investor seeking exposure to large-capitalization stocks can place money with a large-cap active manager or with an index fund that mirrors the S&P 500.

Accordingly, we can consider an appropriate index's return to be a measure of an investor's opportunity cost—the cost of capital—and that beating the benchmark over time should be an active manager's measure of success.

So how do active managers fare against the competition? Not well. Over a recent five-year period, the indexes outperformed about 70% of all active managers, and about three-quarters of active funds underperformed the benchmark over 10 years. And this type of result has been consistent over time.<sup>3</sup> Given how well the indexes have fared, it might be useful to provide a scouting report on how the indexes compete.

The most widely used benchmark for equity fund performance is the S&P 500. The S&P Index Committee uses five main criteria when looking for index candidates. Here they are—the heart of the strategy that beats the majority of active managers, year-in and year-out:<sup>4</sup>

1. *Liquidity.* As the committee wants the benchmark to be “investable,” it selects stocks with sufficient liquidity (a ratio of monthly trading volume divided by shares outstanding of 0.3) and float.
2. *Fundamental analysis.* The profitability criteria are “four quarters of positive net income on an operating basis.” That's it.

Michael J. Mauboussin  
 212-325-3108  
[michael.mauboussin@csfb.com](mailto:michael.mauboussin@csfb.com)

Kristen Bartholdson  
 212-325-2788  
[kristen.bartholdson@csfb.com](mailto:kristen.bartholdson@csfb.com)

3. *Market capitalization.* For the S&P 500, there are no market capitalization restrictions, but “the guiding principle for inclusion in the S&P 500 is leading companies in leading U.S. industries.”
4. *Sector representation.* The committee tries to keep the weight of each sector in-line with the sector weightings of the universe. It typically does so by adding stocks in underweighted sectors, not by removing stocks in overweighted sectors.
5. *Lack of representation.* S&P defines the lack of representation as follows, “If the index were created today, this company would not be included because it fails to meet one or more of the above criteria.” Of the more than 1,000 companies removed from the S&P 500 over the past 75 years, the overwhelming majority were the result of mergers and acquisitions.

Our scouting report of the S&P 500 might also note that the committee does no macroeconomic forecasting, invests long-term with low portfolio turnover, and is unconstrained by sector or industry limitations, position weightings, investment style parameters, or performance pressures. Also critical is that index funds closely track the S&P 500 at a very low cost.

### Evaluating the Winners

Some actively managed funds clearly do beat the benchmark, even over longer time periods. To see if we could come to some stylized conclusions about how these successful investors did it, we created a screen of the general equity funds that beat the S&P 500 over the past decade (ended the most recently reported fiscal year) where the fund had one manager and assets in excess of \$1 billion.<sup>5</sup>

**Exhibit 1: Some General Equity Funds that Beat the S&P 500 (1992–2002)**

Fund Name	Ten Year Return	Ten Year After Tax Return	Turnover	Assets in Top Ten Holdings
Calamos Growth A	18.7%	15.3%	79%	21.5%
Fidelity New Millennium	17.2	14.5	91	30.3
Legg Mason Value Trust	16.6	15.3	25	51.9
WasatchCore Growth	16.0	13.5	76	46.1
JanusSmall Cap Value Institutional	15.8	12.8	39	22.5
Clipper	15.5	12.3	48	51.9
Weitz Partners Value	15.4	13.2	10	50.8
Excelsior Value & Restructuring	15.4	14.7	8	28.1
Weitz Value	14.9	12.9	13	50.1
Longleaf Partners	14.8	12.4	18	57.7
Sequoia	14.8	13.2	8	79.4
Fidelity Low - Priced Stock	14.7	11.6	26	17.1
Smith Barney Aggressive Growth	14.6	13.9	1	53.0
Vanguard Primecap	13.9	12.7	11	35.6
Dodge & Cox Stock	13.8	11.7	13	23.7
Torrey	13.5	12.5	23	40.1
T. Rowe Price Mid Cap Growth	13.5	12.7	36	20.6
Gabelli Value A	13.3	9.9	16	39.9
Longleaf Partners SmallCap	13.2	11.5	17	60.0
Heartland Value	13.0	11.2	49	19.3
American Funds Growth Fund of America	12.7	10.2	30	22.7
Federated Kaufmann K	12.5	10.4	65	34.5
Ariel	12.5	9.9	6	36.9
Scudder Dreman High Return Equity A	12.4	10.2	25	52.0
T. Rowe Price Small - Cap Value	12.3	10.6	12	14.9
Liberty Acorn Fund Z	12.3	10.1	13	13.2
Elfun Trusts	12.1	10.0	9	38.9
Franklin Small - Mid Cap Growth	12.1	10.3	47	16.5
PIMCO NFJ Small Cap Value Institutional	12.1	9.9	40	10.2
Dreyfus Appreciation	10.9	10.2	2	41.9
White Oak Growth Stock	10.5	10.4	15	61.5
<b>Average</b>	<b>13.9%</b>	<b>11.9%</b>	<b>28%</b>	<b>36.9%</b>
Vanguard 500 Index	9.9 %	9.0 %	7 %	24.1%
Vanguard Total Stock Mkt Idx	9.3	8.5	9	19.4

Source: Morningstar.com.

Four attributes generally set this group apart from the majority of active equity mutual fund managers:

- *Portfolio turnover.* As a whole, this group of investors had about 30% turnover, which stands in stark contrast to turnover for all equity funds of 110%. The S&P 500 index fund turnover was 7%. Stated differently, the successful group had an average holding period of approximately three years, versus less than one year for the average fund.<sup>6</sup>
- *Portfolio concentration.* The long-term outperformers tend to have higher portfolio concentration than the index. For example, these portfolios have, on average 37% of assets in their top-10 holdings, versus 24% for the S&P 500 and a 28% median for all U.S. equity funds.
- *Investment style.* The vast majority of the above-market performers espouse an intrinsic value investment approach; they seek stocks with prices that are less than their value. In his famous “The Superinvestors of Graham-and-Doddsville” speech, Warren Buffett argued that this investment approach binds many successful investors.
- *Geographic location.* Only a small fraction of high-performing investors hail from the East-coast financial centers, New York or Boston. These alpha-generators are based in cities like Chicago, Salt Lake City, Memphis, Omaha, and Baltimore.

Based on our S&P scouting report, these managers seem to follow the index’s strategy with regard to turnover and limited time on macro forecasting, and deviate from the index’s strategy with regard to concentration and a sharp focus on price-to-value discrepancies.

We are not suggesting that all investors should or can embrace the approach of this group. A broad ecology of investors comprises a well-functioning market. The market needs investors with varying time horizons, analytical approaches, and capital resources. And many money managers have seen outstanding results pursuing very different strategies than the ones we describe.

Further, it is worth underscoring that the success of these investors is not the result of their portfolio structure (an outcome) but more likely reflects the success of their investment process. We once overheard an investor remark to one of these superior performers, “You can have low turnover because your performance is so good.” At once, the manager shot back, “No, our performance is good *because* we have low turnover.” It would be futile to try to replicate the portfolio attributes (i.e., low turnover, relatively high concentration) without an appropriate process.

That noted, we still must ask the obvious question: Why is the profile of an average fund so different than these superinvestors?

## Investing Profession versus the Investment Business

Part of the answer lies in the tension—and perhaps growing imbalance—between the investment *profession* and the investment *business*. The investment profession is about managing portfolios to maximize long-term returns, while the investment business is about generating (often short-term) earnings as an investment firm. There is nothing wrong with having a vibrant business, of course, and indeed a strong business is essential to attracting and retaining top talent.<sup>7</sup> But a focus on the business *at the expense* of the profession is a problem.

A historical perspective of the mutual fund business suggests a strong swing to the business side. One person uniquely qualified to document the industry’s changes is the legendary Jack Bogle, who over the past half century has been an industry advocate, visionary, and gadfly. Here are some of the profound changes Bogle notes:<sup>8</sup>

- The number of common stock funds has swelled from 75 in 1949 to 4,800 today, and offer greater specialization as well as geographic scope. The number of new stock funds the industry created (as a percentage of those in existence) reached a record of nearly 600% in the 1990s, up from about 175% in the 1980s. Notable, too, is that 50% of funds failed in the 1990s, and almost 900 have failed in the past three years alone.

- Competition leads to margin compression in most industries. But mutual fund expense ratios, which averaged about 90 basis points in the late 1970s and early 1980s, have been *rising* steadily over the past 15 years and now stand at 136 basis points. We can attribute a good part of the fee increase to asset gathering costs. And costs matter: from 1950-1970, funds generated returns that were 87% of the market's. From 1982-2002, that ratio was 76%.
- Until 1958, the SEC restricted sales of management companies. After the courts struck down the SEC's position, the investment management industry saw a flurry of initial public offerings and M&A activity. Of the 50 largest fund organizations today, only six are privately held. Seven are public independent companies, U.S. financial conglomerates (23), foreign financial firms (7), and major brokerage firms (6) own the rest. One mutual remains—Vanguard.
- One non-obvious consequence of active mutual fund marketing, as well as investor proclivity to invest in the latest hot performing funds, is that the *average* fund performance has no resemblance to *actual* investor returns. The reason is that investors pile into where the performance has been, and inevitably suffer as returns revert to the mean. For example, growth stocks saw their greatest quarter of net inflows (\$120 billion) in the first quarter of 2000, coincidental with the Nasdaq's peak, while value funds suffered significant outflows. Bogle calculates that while the market rose 13% from 1982-2002, the average fund return was 10%, but the average investor return was only 2%.

Charley Ellis draws up a list of initiatives an investment firm might pursue to maximize its value as a business. We summarize these in Exhibit 2. Ellis points out that the crux of the tension between the profession and business is that they operate at different rhythms. Long time horizons, low fees, and contrarian investing are good for the profession. In contrast, short time horizons, higher fees, and selling what's in demand are good for the business.

---

#### **Exhibit 2: Pointers to Make an Investment Firm a Business**

---

- ❖ Increase the number and enhance the stature of relationship managers, because whatever the performance, they'll be able to keep clients longer—and retention is key to profit maximization.
- ❖ Charge relationship managers with explicit responsibility for cross-selling more and more asset classes and investment products to each client—to maximize “share of wallet” with each account.
- ❖ Expand the number and improve the industrial selling skills of sales professionals.
- ❖ Develop your organization's “brand” or market franchise.
- ❖ Expand into new markets—at home and abroad.
- ❖ If you are strong in retail, expand into institutional. And if strong in institutional, expand into retail.
- ❖ Focus on mastering relationships with investment consultants, those powerful intermediaries who are involved in 70% of all institutional manager hiring.
- ❖ Extend your firm's product line into new asset classes and into all size variations—to diversify your business risk of dependence on superior investment results.
- ❖ Limit the business risk of unexpected short-run investment results by hewing close to the index.

---

Source: Charles D. Ellis, “Will Business Success Spoil the Investment Management Profession?” *The Journal of Portfolio Management*, Spring 2001, 14.

So what should investment firms do? Ellis says it well:

*The optimal balance between the investment profession and the investment business needs always to favor the profession, because only in devotion to the disciplines of the profession can an organization have those shared values and cultures that attracts unusually talented individual professionals.*<sup>9</sup>

We would argue that many of the performance challenges in the business stem from an unhealthy balance between the profession and the business. Many of the investment managers that do beat the market seem to have the profession at the core.

---

<sup>1</sup> Charles D. Ellis, "Will Business Success Spoil the Investment Management Profession?" *The Journal of Portfolio Management*, Spring 2001, 11-15.

<sup>2</sup> Appendix 1 in Benjamin Graham, *The Intelligent Investor*, 4<sup>th</sup> Edition (New York: HarperCollins, 1985), 291-301.

<sup>3</sup> Burton G. Malkiel, "The Efficient Market Hypothesis and Its Critics," *Journal of Economic Perspectives*, 17, 1, Winter 2003, 78. This is not a new finding. See also Burton G. Malkiel, "Returns from Investing in Equity Mutual Funds 1971-1991," *Journal of Finance*, 50, 2, June 1995, 549-572; Michael C. Jensen, "The Performance of Mutual Funds in the Period 1945-1964," *Journal of Finance*, 23, 1968, 389-416.

<sup>4</sup> [http://www.ifa.tv/Media/Images/PDF%20files/SP500\\_Rules\\_GeneralCriteria.pdf](http://www.ifa.tv/Media/Images/PDF%20files/SP500_Rules_GeneralCriteria.pdf).

<sup>5</sup> Special thanks to Gary Mishuris for creating the initial list and prompting this line of inquiry.

<sup>6</sup> Jack Bogle, using John Maynard Keynes's terminology, contrasts *speculation* ("forecasting the psychology of the market") with *enterprise* ("forecasting the prospective yield of an asset"). Bogle argues that the turnover ratios suggest most investors are speculators. See [http://www.vanguard.com/bogle\\_site/sp20030114.html](http://www.vanguard.com/bogle_site/sp20030114.html).

<sup>7</sup> See Ellis for an excellent exposition of this tension.

<sup>8</sup> Bogle. See [http://www.vanguard.com/bogle\\_site/sp20030114.html](http://www.vanguard.com/bogle_site/sp20030114.html). Also, see "Other People's Money: A Survey of Asset Management", *The Economist*, July 5, 2003 and John C. Bogle, "The Emperor's New Mutual Funds," *The Wall Street Journal*, July 8, 2003.

<sup>9</sup> Ellis, 14.

### Additional Disclosures

This report is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or which would subject Credit Suisse First Boston or its subsidiaries or affiliates (collectively "CSFB") to any registration or licensing requirement within such jurisdiction. All material presented in this report, unless specifically indicated otherwise, is under copyright to CSFB. None of the material, nor its content, nor any copy of it, may be altered in any way, transmitted to, copied or distributed to any other party, without the prior express written permission of CSFB. All trademarks, service marks and logos used in this report are trademarks or service marks or registered trademarks or service marks of CSFB.

The information, tools and material presented in this report are provided to you for information purposes only and are not to be used or considered as an offer or the solicitation of an offer to sell or to buy or subscribe for securities or other financial instruments. CSFB may not have taken any steps to ensure that the securities referred to in this report are suitable for any particular investor. CSFB will not treat recipients as its customers by virtue of their receiving the report. The investments or services contained or referred to in this report may not be suitable for you and it is recommended that you consult an independent investment advisor if you are in doubt about such investments or investment services. Nothing in this report constitutes investment, legal, accounting or tax advice or a representation that any investment or strategy is suitable or appropriate to your individual circumstances or otherwise constitutes a personal recommendation to you. CSFB does not offer advice on the tax consequences of investment and you are advised to contact an independent tax adviser. Please note in particular that the bases and levels of taxation may change.

Information and opinions presented in this report have been obtained or derived from sources believed by CSFB to be reliable, but CSFB makes no representation as to their accuracy or completeness. Additional information is available upon request. CSFB accepts no liability for loss arising from the use of the material presented in this report, except that this exclusion of liability does not apply to the extent that liability arises under specific statutes or regulations applicable to CSFB. This report is not to be relied upon in substitution for the exercise of independent judgment. CSFB may have issued, and may in the future issue, other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. Those reports reflect the different assumptions, views and analytical methods of the analysts who prepared them and CSFB is under no obligation to ensure that such other reports are brought to the attention of any recipient of this report. CSFB and its affiliate companies are involved in many businesses that may relate to companies mentioned in this report. These businesses include specialized trading, risk arbitrage, market making, and other proprietary trading. CSFB may, to the extent permitted by law, act upon or use the information or opinions presented herein, or the research or analysis on which they are based, before the material is published.

Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance. Information, opinions and estimates contained in this report reflect a judgement at its original date of publication by CSFB and are subject to change without notice. The price, value of and income from any of the securities or financial instruments mentioned in this report can fall as well as rise. The value of securities and financial instruments is subject to exchange rate fluctuation that may have a positive or adverse effect on the price or income of such securities or financial instruments. Investors in securities such as ADR's, the values of which are influenced by currency volatility, effectively assume this risk.

Structured securities are complex instruments, typically involve a high degree of risk and are intended for sale only to sophisticated investors who are capable of understanding and assuming the risks involved. The market value of any structured security may be affected by changes in economic, financial and political factors (including, but not limited to, spot and forward interest and exchange rates), time to maturity, market conditions and volatility, and the credit quality of any issuer or reference issuer. Any investor interested in purchasing a structured product should conduct their own investigation and analysis of the product and consult with their own professional advisers as to the risks involved in making such a purchase.

Some investments discussed in this report have a high level of volatility. High volatility investments may experience sudden and large falls in their value causing losses when that investment is realised. Those losses may equal your original investment. Indeed, in the case of some investments the potential losses may exceed the amount of initial investment, in such circumstances you may be required to pay more money to support those losses. Income yields from investments may fluctuate and, in consequence, initial capital paid to make the investment may be used as part of that income yield. Some investments may not be readily realisable and it may be difficult to sell or realise those investments, similarly it may prove difficult for you to obtain reliable information about the value, or risks, to which such an investment is exposed.

This report may provide the addresses of, or contain hyperlinks to, websites. Except to the extent to which the report refers to CSFB's own website material, CSFB has not reviewed the linked site and takes no responsibility for the content contained therein. Such address or hyperlink (including addresses or hyperlinks to CSFB's own website material) is provided solely for your convenience and information and the content of the linked site does not in any way form part of this document. Accessing such website or following such link through this report or CSFB's website shall be at your own risk.

This report is issued and distributed in Europe (except Switzerland) by Credit Suisse First Boston (Europe) Limited, One Cabot Square, London E14 4QJ, England, which is regulated in the United Kingdom by The Financial Services Authority ("FSA"). This report is being distributed in the United States by Credit Suisse First Boston LLC; in Switzerland by Credit Suisse First Boston; in Canada by Credit Suisse First Boston Canada Inc.; in Brazil by Banco de Investimentos Credit Suisse Boston S.A.; in Japan by Credit Suisse First Boston Securities (Japan) Limited; elsewhere in Asia/Pacific by whichever of the following is the appropriately authorised entity in the relevant jurisdiction: Credit Suisse First Boston (Hong Kong) Limited, Credit Suisse First Boston Australia Equities Limited, Credit Suisse First Boston (Thailand) Limited, CSFB Research (Malaysia) Sdn Bhd, Credit Suisse First Boston Singapore Branch and elsewhere in the world by the relevant authorised affiliate of the above. Research on Taiwanese securities produced by Credit Suisse First Boston, Taipei Branch has been prepared and/or reviewed by a registered Senior Business Person.

In jurisdictions where CSFB is not already registered or licensed to trade in securities, transactions will only be effected in accordance with applicable securities legislation, which will vary from jurisdiction to jurisdiction and may require that the trade be made in accordance with applicable exemptions from registration or licensing requirements. Non-U.S. customers wishing to effect a transaction should contact a CSFB entity in their local jurisdiction unless governing law permits otherwise. U.S. customers wishing to effect a transaction should do so only by contacting a representative at Credit Suisse First Boston LLC in the U.S.

Please note that this report was originally prepared and issued by CSFB for distribution to their market professional and institutional investor customers. Recipients who are not market professional or institutional investor customers of CSFB should seek the advice of their independent financial advisor prior to taking any investment decision based on this report or for any necessary explanation of its contents. This research may relate to investments or services of a person outside of the UK or to other matters which are not regulated by the FSA or in respect of which the protections of the FSA for private customers and/or the UK compensation scheme may not be available, and further details as to where this may be the case are available upon request in respect of this report.

Copyright Credit Suisse First Boston, and its subsidiaries and affiliates, 2003. All rights reserved.