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the consilient observer
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con·sil'i·ence, *n.* [con- + salire to leap]
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? [1]

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 [2]

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. [3] 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: [4]

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.

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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.[5]

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
Wasatch Core Growth	16.0	13.5	76	46.1
Janus Small 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
Torray	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 Small-Cap	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
Average	**13.9%**	**11.9%**	**28%**	**36.9%**
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.[6]
- *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.[7] 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:[8]

- 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.* [9]

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.

[1] Charles D. Ellis, "Will Business Success Spoil the Investment Management Profession?" *The Journal of Portfolio Management*, Spring 2001, 11-15.
[2] Appendix 1 in Benjamin Graham, *The Intelligent Investor*, 4th Edition (New York: HarperCollins, 1985), 291-301.
[3] 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.
[4] http://www.ifa.tv/Media/Images/PDF%20files/SP500_Rules_GeneralCriteria.pdf.
[5] Special thanks to Gary Mishuris for creating the initial list and prompting this line of inquiry.
[6] 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.
[7] See Ellis for an excellent exposition of this tension.
[8] Bogle. See 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.
[9] Ellis, 14.

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