INVESTMENT POLICY

How to Win the Loser's Game

After you read this book you will know all you will ever need to know to be truly successful with investments.

CHARLES D. ELLIS

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For Chad and Harold
who gave me the pleasure
of being Dear Old Dad

"We have striven throughout to guard the student against overemphasis upon the superficial and the temporary . . . this overemphasis is at once the delusion and the nemesis of the world of finance."

Security Analysis—1934 Edition.
Benjamin Graham and David Dodd.

Foreword

Charley Ellis has what I like to see in an author. He is extremely knowledgeable about his subject. He is intellectually provocative. And he serves no one master!

Goodness knows, Ellis is equipped to tell us about investment policy. His client base includes investment managers and clients alike, and he has probably observed the very best and the very worst of both as they approach the delicate policy decisions.

Ellis's "loser's game" thesis has been a challenge to all participants and is integral to this book. Ellis believes that equity markets are efficient because of the combined brainpower, knowledge, and diligence of the information seekers who make crucial investment decisions. I believe the loser's game is magnified by a growing masochism of the investment community—particularly the institutional participants. Let's face it, clients and managers are involved in a self-destructive approach which emphasizes shorter-term performance and encourages turnover of both securities and managers. The timing of such moves and the inherent costs of executing the many changes are powerful forces working against everybody but the conduits for such changes, the brokers and market makers.

Whether it's super efficiency or super masochism, the result is the same. Ellis's answer is not to tell you to buy low and sell high. He starts where we all have to start to eliminate bad habits: at the very beginning. It's "back to fundamentals," which means back to the very reasons why you are investing and what your expectations and scope should be in approaching this. As dull as "policy" may sound, this *is* the starting block!

One thing is certain. If you follow Charley Ellis's philosophy, *you will be different.* Few investors I know form strategies as he recommends. If over 30 years in the investment management business has taught me anything, it is that the biggest and most consistent winners are those who are willing and able to act different from others.

As Ellis implies, this takes fortitude. Like sound philosophies generally, however, once you "believe" and make the step, the path is far less burdensome. This is the lesson to be learned from *Investment Policy.* The frenetic behavior of other investors is creating opportunity. This may be one of the few times when the easy way out may be the most productive. In this fine book, Ellis provides the tools to develop a winner's policy.

Claude N. Rosenberg, Jr.

Preface

A large English oak table dominating the inside left corner of the Morning Room on the ground floor of Boodles', the oldest of the social clubs established more than a century ago in or near St. James's in London, is one of the places in which parts of this book were written. Other locations include hotel rooms in—and airplanes flying between—Johannesburg, San Francisco, Chicago, Nairobi, Princeton, Bermuda, Vail, Boston, New York City, and Atlanta; and of course, at home in Greenwich.

Because my priorities have been my commitments to my family and to the clients of Greenwich Associates, completing this small book has taken a very long time. This long period of gestation has been advantageous to the final result because it has given me the time and opportunity to obtain and incorporate some of the wisdom and knowledge of thoughtful others.

Several friends have given generously of their time and experience in reading and criticizing the various stages of development through which this book has passed on its way to its present form.

Claude N. Rosenberg, Jr., saved it from the oblivion to which it might have been consigned by insisting on a client focus and joshing me out of an inclination toward the stiffness of "academic" writing. Credit for readability belongs to Claude.

Dean LeBaron encouraged me with a delightful mixture of friendly admonition and cheerful "*pourquoi non?*" that must have masked some genuine doubts.

William G. Burns of NYNEX, Karl Van Horn of American Express Asset Management, and Chris Argyris of Harvard all gave me particularly useful comments and raised questions that lead to additions in several key sections that I will always want to claim.

Robert H. Jeffrey gave the kindest compliment by reading each section with the rigor of a Jesuit instructor and offered extensive suggestions on the main theory and on the structure of the argument—and even on choice of words. Any writer would be grateful for the chance to experience such insistent and gracious thinking and editing.

Dero Saunders applied his considerable talents as an editor and instructor in two complete rewritings. I now know why he expects to be remembered as the editor who could remove four lines from the Lord's Prayer without anyone noticing.

Susan Ellis, as she has done so many times before, used her clarity of mind to bring order and consistency to the language and strength to the exposition.

Lucy Carino, Ann Del Grande, Jeanne Gans, Sandy Jones, and Debra Jo Pennell, all members of Greenwich Associates, typed and retyped the all too numerous drafts through which the final text "evolved."

Special thanks are due to dozens of senior investment professionals who have participated in a series of three-day seminars on investment policy and practice—sponsored by my friends and former partners at Donaldson, Lufkin, and Jenrette—which it has been my great privilege to lead for nearly 20 years. Many of the ideas in the book have been developed at these seminars.

Finally, I wish to recognize explicitly my admiration and respect for the large number of extraordinarily talented, resourceful, and hardworking men and women who compete for success at our nation's investing institutions and securities firms. It is a profound but ironic compliment that their skillful striving is what has made it possible to propose the approach advocated in this book to investment policy.

Charles D. Ellis

Contents

1

Do Clients Matter?

After you read this book, you will know all you will ever need to know to be truly successful with investments.

For such a small book, this ambition may seem far too bold. But there is a countervailing modesty.

This book does not intend to explain how to be successful at traditional investment management—how to pick stocks, time markets, or execute major strategic shifts in a portfolio. Such a treatise would certainly require far greater length. It would be written for professional investment managers as producers and sellers of investment services. And it would be based on the assumption that it is feasible to outperform other investors in the active-aggressive kind of investment management that dominates institutional investing today. This basic assumption must now be in question[1]—only because so many talented, informed, experienced, and diligent professionals are working so hard at institutional investing that they make it unrealistic for any one manager to outperform these other professionals.

This book is different. Far from accepting the conventional wisdom that talented, competitive, professional investment man-

[1]Fifteen years ago when I was writing *Institutional Investing* (also published by BUSINESS ONE IRWIN) it made sense to prescribe and advocate a strategic approach to active management. Today, the world of investment management is different, and the time has come for a different concept of the problem of investing and an appropriately different concept of the solution.

agers can beat the market, it questions closely the whole concept of institutional investing as it is practiced today.

This book is not written for the sellers of investment management services. It is written for the buyers who, as clients of professional investment managers, have a real responsibility to themselves to understand the basic nature of institutional investing, why investment managers succeed or fail, and what can be done to achieve long-term investment success, even when their professional investment managers are failing to beat the market.

This consumers guide to investment management is designed to meet the needs of the many individual investors who entrust their family savings to mutual funds, trust companies, and investment advisors; the needs of the corporate executives, union, and public officials responsible for pension funds; and the needs of the men and women who serve as trustees of the endowments of universities, museums, schools, hospitals, and foundations.

This book is written with a clear point of view; clients of investment managers all too often delegate or more accurately abdicate to their investment managers responsibilities which they can and should keep for themselves. Their undelegatable responsibilities are: setting explicit investment policies consistent with their objectives, defining long-range objectives which are appropriate to their particular fund, and managing their managers to ensure that their policies are being followed.

This book is a guide for those who will accept this central client responsibility and who want to be active, responsible, and successful; whether as fiduciaries or for their own account.

Much as it might seem obvious that client investors should care a lot about the way their money is managed, the reality is they typically do almost nothing about it—until it's too late.

Despite the fact that everybody "knows" that each family fortune or pension fund or endowment fund differs in situation from every other fund (and that these differences are often quite substantial), and despite the conventional consensus that these substantial differences should be reflected in different investment policies and practices, the plain fact is that the investment portfolios of most funds are very much alike.

This is not the way it should be. The needs and purposes of the funds are not the same and their investment portfolios should not be the same.

Regression to the mean is a powerful phenomenon in physics and sociology—and in investments.

Without clear direction from their clients, it is natural for investment managers to move toward the center, to put portfolios in neutral, to be conventional. (It is also easier to treat all clients the same.) In other words, investment managers will tend to produce average portfolios for *all* their clients rather than portfolios that are carefully designed to meet the particular objectives of each individual client.

At the same time, ironically, professional investment managers lament over and over again that they feel they must compromise their investment decisions because clients do not do their part. In particular, managers believe they could achieve far better results if their clients took a longer-term view of the investment process and if their clients would only be more specific about the kind of investment portfolio they really want.

Clients "own" the central responsibility for formulating and assuring implementation of long-term investment policy. As has been suggested and will be shown, this responsibility cannot be delegated to investment managers. Fortunately, this client responsibility can be fulfilled without extensive experience in securities analysis or portfolio management.

To fulfill their responsibilities to themselves, clients need three characteristics: (1) a genuine interest in developing an understanding of their own true interests and objectives, (2) an appreciation of the fundamental nature of capital markets and investments, and (3) the discipline to work out the basic policies that will, over time, succeed in achieving their realistic investment objectives. That's what this book is about.

Investment managers will also find this book useful in providing a context for the work to which they devote so much of their time and skill—the day-to-day management of investment portfolios. Managers should encourage their clients to use this book as a guide to performing the vital role of being informed, active, and *successful* clients.

While it is a spirited critique of contemporary practice in institutional investing, this book is by no means a condemnation of investment managers. The problem is not that professional managers lack skill or diligence. Quite the opposite. The problem with trying to beat the market is that professional investors are so talented, so numerous, and so dedicated to their work that as a group they make it very difficult for any one of their number to do significantly better than the others, particularly in the long run.

There are two different kinds of problems in trying to beat the market. One problem is that it is so very difficult to do—and so easy, while trying to do better, to do *worse*. The other problem with targeting on beating the market as a primary investment objective is that this focus diverts the attention of both the investment manager and the client from the need to establish long-range objectives and investment policies that are well matched to the particular needs of the individual client. The real purpose of investment management is not to "beat the market," but to do what is really right for a particular client. And making sure the manager concentrates on achieving that objective is the responsibility of the client.

Does the client matter? Indeed he *should*. But the client will only matter if he asserts his authority and fulfills his responsibility: deciding investment objectives, developing sound investment policies, and holding portfolio managers accountable for implementing long-term investment policy in daily portfolio operations.

2

The Loser's Game

Disagreeable data are steadily streaming out of the computers of the performance measurement firms. Over and over again, these facts and figures inform us that investment managers are failing to "perform." Occasional periods of above average results raise expectations that are soon dashed as false hopes. Contrary to their often articulated goal of outperforming the market averages, the nation's investment managers are not beating the market; the market is beating them.

Faced with information that contradicts what they believe, humans tend to respond in one of two ways. Some will ignore the new knowledge and hold to their former beliefs. Others will accept the validity of the new information, factor it into their perception of reality, and then put it to use.

Investment management, as traditionally practiced, is based on a single basic belief: Professional investment managers *can* beat the market. That premise appears to be false, particularly for the very large institutions that manage most of the assets of most trusts, pension funds, and endowments, because their institutions have effectively become the market.

If the premise that it is feasible to outperform the market were acceptable, then deciding *how* to go about achieving success would be a matter of straightforward logic.

First, since the overall market can be represented by a passive and public listing such as the Standard & Poor's 500 Stock

Index, the successful manager need only rearrange his portfolios more productively than the "mindless" S&P 500. He can be different in stock selection, or strategic emphasis on particular groups of stocks, or market timing, or in various combinations of these.

Second, since the active manager will want to make as many "right" decisions as possible, he will assemble a group of bright, well-educated, highly motivated, hardworking professionals whose collective purpose will be to identify underpriced securities to buy and overpriced securities to sell—and to beat the market by shrewdly "betting against the house."

Unhappily, the basic assumption that most institutional investors can outperform the market is not true. The institutions *are* the market. They cannot, as a group, outperform themselves. In fact, given the cost of active management—fees, commissions, and so forth—most large institutional investors will, over the long term, underperform the overall market.

Because investing institutions are so numerous and capable and determined to do well for their clients, investment management is not a winner's game. It is a loser's game.

Before analyzing what happened to convert institutional investing from a winner's game to a loser's game, consider the profound difference between these two kinds of games. In a winner's game, the outcome is determined by the winning actions of the *winner*. In a loser's game, the outcome is determined by the losing behavior of the *loser*. The conceptual distinction can be made entertaining by quoting an eminent scientist, a distinguished historian, and a renowned educator. They are, respectively, Dr. Simon Ramo of TRW; naval historian Admiral Samuel Elliot Morison; and professional golf instructor Tommy Armour.

Simon Ramo identified the crucial difference between a winner's game and a loser's game in his excellent book on playing strategy, *Extraordinary Tennis for the Ordinary Tennis Player.*[1] Over a period of many years, Dr. Ramo observed that tennis was not one game, but two—one played by professionals and a very few gifted amateurs; the other played by all the rest of us.

Although players in both games use the same equipment, dress, rules and scoring, and conform to the same etiquette and customs, the basic natures of their two games are quite differ-

[1]Simon Ramo, *Extraordinary Tennis for the Ordinary Tennis Player* (New York: Crown Publishers, 1977).