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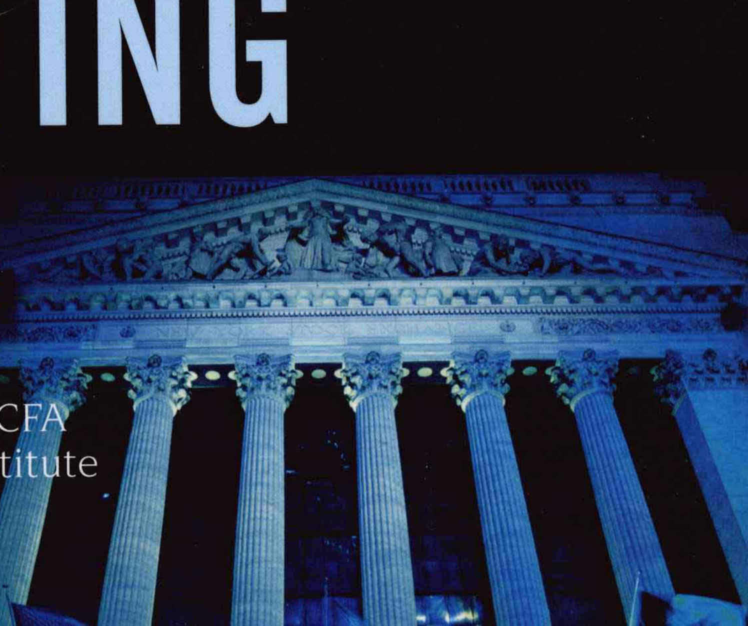
TREYNOR ON INSTITUTIONAL INVESTING

JACK L. TREYNOR



Foreword by Jeff Diermeier, CFA
President and CEO, CFA Institute

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Treynor on Institutional Investing

JACK L. TREYNOR

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To Betsy Glassmeyer Treynor,
who changed my life from black and white to Technicolor.

Foreword

Jack L. Treynor: An Independent Mind

This book, a collection of the writings of one of the most independent minds to tackle the financial market landscape, captures a number of ways in which the ever-provocative Jack Treynor influenced and touched the professional investment community over a period of decades. He reached many of us in two ways: (1) through published pieces of foresight and analysis that are now well recognized, and (2) through the individual guidance and advice that he has given to many of us. The book is part of a growing trend to recognize the many, and important, accomplishments of this esteemed practitioner.

If there is one way to sum up the contributions made by Treynor (and Walter Bagehot, his pseudonym for articles in CFA Institute's *Financial Analysts Journal [FAJ]*), it was captured in Perry Mehrling's book on the late Fischer Black.[1] Treynor is credited by many scholars with drawing Black into the world of finance, and the two collaborated and counterpointed for years. Speaking in 1997 at a meeting of the International Association of Financial Engineers, Nobel Laureate Paul Samuelson suggested that a "Hall of Fame of Theoretical Finance" list should include Myron Scholes, Robert Merton (who would go on to be awarded Nobel Prizes), and Fischer Black (who died before he could receive a Nobel). In the middle of his speech, after mentioning the innovation of the capital asset pricing model (CAPM) for which William Sharpe had won the Nobel Prize in 1990, another Nobel Prize winner, Franco Modigliani, rose and said, "What about Treynor? You forgot Treynor!"

He knew Treynor had developed a CAPM in 1962, because Treynor had shown the model to him, and Modigliani regretted that he had not seen its potential and encouraged Treynor to pursue it. "I made a mistake with Treynor," he has noted. Treynor discovered the CAPM as a part of a journey to find better answers to the question of what was the appropriate discount rate to be used in capital-budgeting projects.

Ultimately, Black would write a letter of appreciation to Treynor as he was stepping down as editor of the *FAJ*, which read:

> *Your own research has been very important. You developed the capital asset pricing model before anyone else. But perhaps your greatest contribution has been through the work of others as Editor of the* Financial Analysts Journal. *Balancing academic interest, readability, and practical interest in a unique way, you guided issue after brilliant issue toward publication. I hope the profession will be able to repay you in some way.*[2]

CFA Institute, representing the investment profession, broadly, owes a huge debt to Jack Treynor. In 1981 as Treynor's term with the *FAJ* was coming to a close, Charley Ellis, CFA wrote:

> *Financial analysts have been striving for many years to develop a strong profession. A profession depends explicitly upon a comprehensive body of knowledge. Great progress in developing our professional knowledge has been made, but not without the stress of working it out piece by piece and stage by stage. Jack has been a leader in the process of developing our knowledge and our understanding, and he has taken us with him.*[3]

It is long past time for his writings to be gathered into a book that should grace the shelf of every investment professional.

Since the mid-1980s, Treynor has been president of Treynor Capital Management in Palos Verdes Estates, California. Following a major in mathematics from Haverford College, a stint with the U.S. Army, and an MBA with Distinction from the Harvard Business School (after which he stayed on at H.B.S. as a case writer for Bob Anthony in accounting), he was hired by the Operations Research Department at Arthur D. Little in 1956. Subsequently, he was hired by Donald Regan (the same Regan who later became U.S. Treasury Secretary) at Merrill Lynch to provide quantitative investment services to institutions. From 1969 to mid-1981, he presided as editor of the *FAJ* of what is now CFA Institute. After he left the *FAJ*, from 1981 to 1985, he was general partner and chief investment officer at the investment management firm of Treynor-Arbit Associates.

In 1985, Treynor earned from CFA Institute the prestigious Nicholas Molodovsky Award, which is presented periodically to individuals who have made outstanding contributions to change the direction of the investment profession. In 2007, he received from CFA Institute our highest commendation—the Professional Excellence Award for exemplary achievement, excellence of practice, and true leadership that have reflected honor upon the investment profession to the highest degree. He is a Distinguished Fellow of the Institute for Quantitative Research in Finance and has received the Employee Benefit Research Institute's Lillywhite Award.

Treynor is the coauthor of two books and more than 90 papers published in, among others, the *Harvard Business Review, Journal of Business, Journal of Finance, Journal of Investment Management, Journal of Portfolio Management,* and *FAJ*. He has taught investment courses at Columbia University and the University of Southern California and has served as director for several investment companies.

This book is more than a valuable collection of some of the leading-edge thoughts of the day by a gifted individual. It is a celebration of a practitioner who, arguably, had more influence over the profession than any other. It celebrates a person whose prime characteristic is an independence of views. In Treynor's own words, his true interest always "was the analytical problem behind investment decisions."[4] Or as Black wrote, "You started me out in finance and showed me the beauty of the way markets balance bulls and bears, speculators and investors. You taught me to look for buried treasure rather than surface nuggets in the unexplored wilds of research."[5]

In fact, Treynor was capable of connecting dots from far enough afield to the seeming point of eccentricity. How else to characterize someone who would bring a jar of red beans into his classroom at the University of Southern California to make a point? He would ask the students to guess how many beans were in the jar. Although the guesses ranged widely, Treynor was able to show that the average guess was close to perfect.

Surface nuggets are illusory. As a result, Jack would test an investment idea by telling others about it. If they easily understood the idea and agreed with the implied conclusion, he would presume the idea was already reflected in the security's price and move on. If they didn't see the point, he would conclude that the view was not impounded in the security's price and would pursue the idea further. I must admit I used the same tactic—usually on relatively sophisticated but unsuspecting investors—when I was in active management. So, of course, you can imagine my delight and disappointment when my old U.S. Equity team admitted that they were using *me* in the same manner after I was promoted to chief investment officer. When I was that one step farther away from the action, I no longer had the "edge." Let that be a warning.

Much of Treynor's work was being done at a time when academia was generally focused on a theory of market efficiency. On that subject, Treynor's statement is what sustains many an applied manager today:

> *[A]lthough the market is highly competitive, market efficiency as such should not prevent active investors from outperforming the market, by capitalizing on either inefficiencies in the propagation of information or inefficiencies in valuation.* [6]

Treynor's broad contribution can be seen in the way the material of this book is organized. Many know that his work goes well beyond capital asset pricing and the performance measurement extension. The headings of this book give evidence to this breadth:

Risk

CAPM

Performance Measurement

Economics

Trading

Accounting

Investment Value

Active Management

Pensions

Cases

Miscellaneous

Treynor makes important contributions in a number of areas that are fundamental to the investment management profession as a whole and CFA Institute in particular. His work addresses most of the ten topic areas that are the foundation for the CFA Program's examinations. Articles addressing the need to measure risk, valuation, capital asset pricing, capital budgeting, bond quality, active versus passive management, earnings quality, and options theory are but a few covered by this prolific writer. But his work extends beyond core topics and speaks to the whole of the investment business. For example, the CFA Institute Centre for financial Market Integrity is organized into four areas: standards of practice, capital markets policy, investment performance standards, and corporate disclosure. Treynor has made analytical contributions to each of these areas, which are traditionally thought of as advocacy.

In his early editorials and articles in the *FAJ* on stewardship, Treynor argued that investment practitioners, to be worthy of being called *professionals*, needed to move away from a focus on the securities industry toward a focus on the ultimate customer. He was critical of the emphasis on persuasion rather than performance. The principle, he believed, should not be what could be sold in the market for the benefit of Wall Street but the intrinsic value of the investment to the end user—whether beneficiary of a pension plan or mutual fund investor. We at CFA Institute also believe that the ultimate owner should be the prime beneficiary of the work we do.

With William Priest and Patrick Regan, Treynor correctly predicted the difficulties our pension system would face under ERISA and the Pension Benefit Guaranty Corporation, both created in 1974.[7] His early work on performance estimation was geared toward giving clients some rational means by which to look through the clutter of all the numbers to make inferences of skill on the part of investment managers, which is a foundation of the CFA Institute's work with Global Investment Performance Standards (GIPS). And his early papers on the accounting-driven nature of earnings statements, versus the investor need for statements that showed the economic rent firms were capturing, were a bulwark on which our voice for the financial statement user could be based. Moreover, he has written on securities law and regulation.

Equally important to Treynor's public contributions, but impossible to quantify, is the individual guidance and advice that he gave to individuals. Many of us can share stories of how Jack Treynor helped and influenced us on a personal scale, even though most of us doubt that he would even remember us. Allow me to share a couple of my own stories.

As the new volunteer head of the Candidate Curriculum Committee for economics at CFA Institute in the mid-1980s, I was struggling to find relevant material of an economic nature for the company research element of our examinations. From an economist's viewpoint, security analysis seemed to sit in a bit of a wasteland between economic theories of supply and demand and accounting approaches to financial statement analysis. Where were the economically principled articles to help a security analyst actually estimate cash flows? I called around and, of course, was directed to Jack Treynor. His first thought was to look at the appendix of John Burr Williams's 1938 gospel on valuation, in which the competitive position and evolution of the General Motors Company were described.[8] From that book, our discussion led to Michael Porter, Mike Spence, and Barry Nalebuff.[9] We accurately concluded there was, seemingly, a lack of supply–demand analysis in the practitioner world. We had great theory, but Jack also provided the applications.

The firm Treynor-Arbit evolved in 1985 out of American National Bank, a midsized gem in Chicago (American National was a pioneer in index fund investing with Rex Sinquefield). I was working down the street at First Chicago. When I took over the investment management function of domestic equities, two external firms had a large impact on what I subsequently attempted to do. One was Treynor-Arbit, with its extremely rigorous and nearly academic (by practitioner standards) approach to uncovering and documenting errors the market was making in understanding and pricing of industries and groups of securities. Here was a model of research, in my mind, that I could borrow from. And I did. It helped that I knew a few of Treynor and Hal Arbit's analysts.

Finally, in 1988, while I was working on a chapter on capital markets for Maginn and Tuttle's textbook, I needed to think particularly carefully, for various reasons, about the relevance of technical analysis.[10] No disrespect intended, but most books and articles on technical analysis at the time lacked rigor and care—despite the fact that much quantitative management is, essentially, sophisticated technical analysis. Treynor's presentation and writings on technical analysis provided a thoughtful way to get one's arms around this oft-used paradigm. This instance provides a valuable lesson: If you really understand deeply the nature of research and markets, you can understand how even easily dismissed theories have elements of value.

This book contains many wonderful articles. You could not do better than to sit down and enjoy them today, years after they were written, both for the perspective they provide and the timeless nature of some of them. I'm sure you'll see as you work through this volume the great independent mind that is Jack Treynor.

We also and always hope you use this book to continue your commitment to fair and free capital markets built on a foundation of trust and bred from the integrity of market participants and professionals like you.

JEFF DIERMEIER, CFA
President and chief executive officer
CFA Institute
April 2007

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Notes

1. *Fischer Black and the Revolutionary Idea of Finance* (Hoboken, NJ: John Wiley & Sons, 2005).
2. "An Open Letter to Jack Treynor" (July–August 1981): 14.
3. "Jack Has Never Been Easy" (July–August): 25.
4. "Ideas for the People Who Make Decisions," *FAJ* (July–August 2005): 6–8; reprinted in *Bold Thinking on Investment Management* (Charlottesville, VA: CFA Institute, 2005): 238–240.
5. "An Open Letter to Jack Treynor," *FAJ* (July–August 1981):14.
6. "What Does It Take to Win the Trading Game?" *FAJ* (January–February 1981): 57.
7. See *The Financial Reality of Pension Funding under ERISA* by Jack L. Treynor, Patrick J. Regan, and William W. Priest, Jr. (Homewood, IL: Irwin, 1976).
8. *The Theory of Investment Value* (Cambridge, MA: Harvard University Press).
9. Porter's influential books at that time were *Competitive Strategy: Techniques for Analyzing Industries and Competitors* (New York: Free Press, first published in 1980) and *Competitive Advantage: Creating and Sustaining Superior Performance* (New York: Free Press, first published in 1985). A. Michael Spence won the Nobel Prize in Economics in 2001 for work on the dynamics of information flows and market development. Barry

Nalebuff is coauthor with Avinash Dixit of *Thinking Strategically: The Competitive Edge in Business, Politics, and Everyday Life* (New York: Norton Paperback, 1993; first published in 1991).

10. The book was *Managing Investment Portfolios: A Dynamic Process* by John L. Maginn and Donald L. Tuttle; the third edition includes editors Jerald E. Pinto and Dennis W. McLeavey (Charlottesville, VA: CFA Institute, 2007).

Preface

Much of the pressure on investment institutions comes from two facts:

1. Results are made public.
2. For every winner there is a loser. Every investor can benefit from a rising market, but what he gains from trading, his counterparty loses.

Not surprisingly, money managers haven't been willing to stand pat with comfortable rituals. They want to know what works—and what doesn't work.

Because most retail investors can't afford to own enough stocks to be well diversified, they can't readily measure the market component of their return. So they don't know whether they are gaining or losing from their trading. Without a meaningful learning experience, retail investors make the same mistakes over and over again.

Since most institutional portfolios—mutual funds, pension funds, endowment funds—hold dozens, if not hundreds of stocks, they are reasonably well diversified, making it easier to distinguish between the two kinds of gains and losses. Perhaps it isn't entirely accidental that institutional investors have been steadily advancing their understanding of the investment problem. As the gap in understanding relative to retail investors has widened over the last 40 years, institutional investing has exploded into a profession that manages more than $26.5 trillion[1] in the United States alone.

Many retail investors with demanding jobs reach a point in their careers where their own investment portfolio has become too important to ignore any longer. They know they are good at making business or professional decisions, but they sense that investment decisions are different. Fortunately, money management isn't rocket science. Whether they want to make conversations with an advisor more rewarding or prepare themselves for responsibilities on the boards of pension, endowment, or mutual funds, this book can be helpful.

The articles draw on the author's experience as a management consultant, money manager, and fund director.[2] First published in the *Harvard Business Review*, the *Journal of Business*, the *Journal of Finance*, the *Journal of Portfolio Management*, the *Journal of Investment Management*, and, of course, the journal the author edited for many years—*Financial Analysts Journal*, more than 16 of the papers in this book have been included in anthologies of finance and investing.

JACK L. TREYNOR
Palos Verdes Estates, CA
April 2007

Notes

1. Pazarbasioglu, Ceyla; Mangal, Goswami; Jack, Ree. "The Changing Face of Investors," *Finance and Development, A quarterly magazine of the International Monetary Fund*, March 2007.
2. The author's consulting experience included casework for Philco, United Fruit, Royal Dutch Shell, the Irish Sugar Company, American Brake Shoe, British Aircraft Corporation, Minneapolis Honeywell, and others. He was a money manager for Treynor-Arbit Associates and fund director for over 30 years with Eaton Vance and its predecessor firms.

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The Center for Research in Security Prices (CRSP) at the University of Chicago—to Jim Lorie and CRSP.

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London Business School—to Dick Brealey and Steve Schaefer.

Northwestern University—to Robert Korajczyk and Al Rappapport.

The Institute for Quantitative Research in Finance—to Roger Murray, Jim Farrell, Gifford Fong, and Peter Williamson.

CFA Institute—to Don Tuttle and John Maginn.

And to Fischer Black.

J. L. T.

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