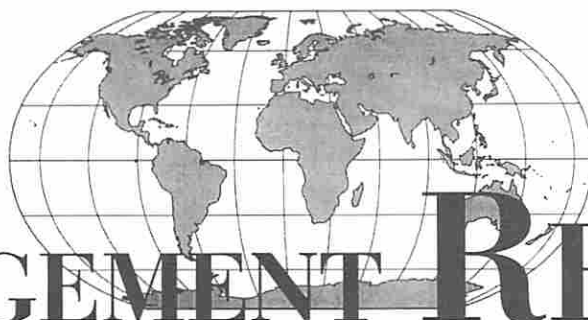


# TAM ASSET MANAGEMENT REVIEW

Modern Investment Principles  
For Serious Investors

November, 1994

Vol. 2 No. 11



Every client of TAM Asset Management receives a copy of Charles D. Ellis' book *Investment Policy*. This book is one of the most useful, objective, and contemporary sources on prudent investment strategy. 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.

Reprinted from *Investment Policy, 2nd Edition*, by Charles Ellis with the permission of Irwin Professional Publishing. All rights reserved. For ordering information, call 1-800-634-3966.

## The Purpose of Policy

### *Investment Policy: How to Win the Loser's Game*

By Charles D. Ellis (Part 12 of 14)






The high purpose of investment policy, and of the systematic discovery process prerequisite to it, is to establish useful guidelines for investment managers that are genuinely appropriate to the realities both of the client's objectives and the realities of the investments and markets. These are the internal and the external realms of investing, and investment policy must be designed to work well in both realms. In addition, good investment policies are "right" for both the long term and for the many short-term periods that will be experienced in the market. And both clients and managers will hold to them when they are most uncomfortable.

The value of a set of investment policies depends on the understanding incorporated in them. First come the client's objectives and tolerances of risk. This is the responsibility of the client to develop and of the manager to understand. Second is the external realm of investments and markets, which is the investment manager's responsibility to understand and explain fully to the client.

Developing understanding of both dimensions of investment policy and how they can be fit together is a puzzle well worth

*Continued on next page...*

### Asset Class Returns\* Through October 31, 1994

	<u>United States</u>	<u>YTD 1994</u>
	1-Yr. Bonds	+2.2%
	5-Yr. Bonds	-2.7%
	Large Stocks	+3.5%
	Large Value Stocks	-1.2%
	Small Stocks	+6.5%
	Small Value Stocks	+3.7%
	<u>International</u>	
	Large Stocks	+13.0%
	<u>Japan</u>	
	Small Stocks	+36.5%
	<u>Continental Europe</u>	
	Small Stocks	+15.4%
	<u>United Kingdom</u>	
	Small Stocks	+10.5%
	<u>Pacific Rim</u>	
	Small Stocks	-3.3%

The markets reversed their trend and headed higher in October. However, reacting to another interest rate increase by the Fed, the markets once again headed lower at the end of November. Charles Ellis' wisdom in this issue's article—"both clients and managers will hold to [good investment policies] when they are most uncomfortable"—is very appropriate under these circumstances.

\*See "Performance Notes" on back page for explanations.

### TAM Portfolio Returns Net of Fees\*

Through October 31, 1994

Risk (% stocks)	Year-to-Date		Since Inception
	1994	1993	12/92-10/94
Aggressive (95%)	+10.2%	+21.1%	+33.4%
Growth (85%)	+6.6%	+16.6%	+24.1%
Moderate (65%)	+5.2%	+14.0%	+19.9%
<b>Benchmarks Comparisons</b>			
Balanced Fund Index	-0.7%	+11.7%	+10.9%
Capital Apprec. Index	+0.1%	+14.8%	+14.9%
S&P 500 Stock Index	+3.7%	+10.1%	+14.1%
Salomon Broad Bond Index	-3.3%	+9.9%	+6.3%

\*See "Performance Notes" on back page for explanations.

This newsletter is published by TAM ASSET MANAGEMENT, INC. • 10 H Street • San Rafael, CA 94901 • 415-456-2905  
Editor: Jeffrey C. Troutner • Comments, questions or suggestions are always welcome.



For information on our investment management services, please call 1-800-TAM-401K (826-4015).

working out. Investment policy is the explicit linkage between the client's long term investment objectives and the daily work of the investment manager. If policy is *not* determined through carefully developed mutual understanding, it *will* be determined in uninformed, anecdotal "ad hoc" manner. To the extent that both client and investment manager understand the realities of the situation as a whole, they will be able to understand what individual bits of data and specific events mean and do not mean for the portfolio they are managing together.

The usefulness of investment policy depends on the clarity and rigor with which investment objectives and the policy guidelines established to achieve those objectives are stated.

The new investment language derived from modern portfolio theory makes it relatively easy to specify investment objectives and policies and to measure portfolio operations to be sure they are in conformance with agreed-upon policy. This language makes genuine investment counseling possible and should make it feasible for each portfolio manager to achieve excellent performance—not by heroically beating the market, but by faithfully and sensibly carrying out realistic investment policies to achieve agreed-upon objectives for each client. It is now practical for investment managers and clients to agree objectively on each of these important policy dimensions:

1. The level of market risk to be taken.
2. Whether the level of risk is to

be sustained or varied as markets change.

3. Whether individual stock risk or group risk are to be taken or avoided, and the incremental rate of return which such risks, when taken, are expected to produce in the portfolio.

Where deliberate differentiation from the market is expected of the investment manager, it will always be wise to establish explicit agreement as to the nature of the differentiating investments that could be made, the circumstances under which they may be made, and the investment concept that gives the manager and client confidence that they will achieve favorable incremental results by taking action.

The conceptual simplicity of setting an explicit policy on market risk and agreeing on how the portfolio will be differentiated from a diversified market fund is clearly appealing in theory. As might be expected, there are practical problems with the implementation. Because investing is a sampling process, the measurement of performance, as we will see in more detail in Chapter 11, can only be done in probabilistic terms. In measuring investment portfolios, we now have good tools, but we do not have precision instruments. There are difficulties with so-called sampling errors, because companies change and stocks change in their investment characteristics. Even if we strive to estimate and adjust for these changes, there will be "noise" in the data investment managers and their clients are working with. We have a new technology that

enables us to communicate more efficiently than before; but the technology is still imperfect, and communication will require patience and tolerance.

There are two major reasons for producing good investment policy guidelines. First in the minds of many is to have a standard by which to monitor managers. As important as this is, the other reason is paramount: to decide what each client's own realistic long-term investment goals should be.

Time, as we have seen, is the single most important factor that separates the appropriate investment objective of one portfolio from the appropriate objective of another portfolio. Specifically, it is the length of time over which the portfolio can and will remain committed to a sustained investment policy, and over which the client will patiently evaluate investment results versus his objectives and policies.

Liquidity should not be given separate consideration in a well diversified portfolio *provided* that portfolio is invested in the kind of securities appropriate to its portfolio duration. For example, even the largest equity portfolio could easily and efficiently be liquidated in a year.

But if only a year's time were available to the portfolio, it should not be invested in equities at all. It should be in money market instruments for safety of principal protection against unanticipated changes in market price. Sufficient liquidity always comes along automatically when investment policy is

*Continued on next page...*

---

*The Purpose of Policy (cont.)*

soundly conceived and implemented.

A puzzling practice, commonly followed in managing pension funds, is maintaining so-called liquidity reserves. The basic reality of the typical pension fund is that it will have a positive cash flow from contributions every year for another generation or more, and so has no need whatever for a liquidity reserve.

Income requirements are excluded from this discussion of investment policy because the rate of return for an investment portfolio can not be increased just because a client wants more money to spend. It is indeed a curious idea that the investment objective for a portfolio should be set according to the funds the investor wants to spend each year. Sometimes this idea shows up in pension funds where the actuarial rate of return assumption will be put forth as a guide to investments. Sometimes it shows up with college presidents insisting on higher endowment fund income to make up for operating deficits. And sometimes it arises when personal trust funds are asked to finance a more expensive way of life. In all its forms, this practice is nonsense. On the contrary, instead of spending decisions influencing investment decisions, it should be the other way around. Spending decisions should most definitely be governed by the investment results—which follow from investment policies.

Investment policy should be separated from investment operations because they are such different responsibilities.

Typically, however, responsibility for both investment policy and operating management of the portfolio are “delegated” to investment managers. Mixing together investment policy and portfolio operations—problem definition and problem solving—and delegating *both* to investment managers is not appropriate.

Formulation of long-term investment policy should be clearly and explicitly separated from the operating responsibilities of portfolio management. Only by separating portfolio operations from policy formation can responsibility and accountability be established for each of these two different aspects of investment management.

Portfolio operations should clearly be the responsibility of the investment manager. Policy is the responsibility of the client. Of course, they are not kept in isolation from each other. Operating performance will be evaluated objectively against the specified policy intention to be sure operations are in accord with policy. And investment policy will be evaluated objectively against long-term returns in the portfolio to be sure the policies are realistic.

An important advantage arising from the separation of investment policy from portfolio operations is the opportunity to control portfolio managers who, because they are human, are tempted to move away from long-term policy—particularly at the high and low points in a market cycle—too cautiously minimizing market risk at lows and too boldly accepting greater

risk at the high point.

Segregating responsibility for investment policy from responsibility for portfolio operation is an essential first step in the work of managing the managers—removing the “what” and obliging them to concentrate entirely on the “how”—so their natural preoccupation with present market conditions will not corrupt the portfolio’s long term policy. The time horizons of investment managers are typically shorter, often much shorter, than the client’s time horizon. Clients should understand this and insist on having *their* time horizons prevail.

Having established investment objectives that are realistic in the market context and appropriate to the time horizon and risk preferences of the investor, it is appropriate to specify the investment policies to be followed by the investment manager in pursuit of these stated objectives.

It is by direct comparison with these explicit investment policies—and *only* by comparison with these explicit policies—that the operational performance of the investment manager should be measured and evaluated.

For example, it would be both unfair and misinforming to attempt an evaluation of the operational performance of a portfolio of growth stocks (or utility stocks or foreign stocks or high-yield stocks) by comparing its results with the overall market averages, because such a comparison is evaluating a mixture of both policy *and* operations that should be exam-

*Continued on next page...*

## The Purpose of Policy (cont.)

ined separately. Specifically, the operational performance of a growth stock portfolio should be critiqued in comparison with an index of growth stocks or portfolios of growth stocks. In the same way, a manager of utility stocks should be evaluated only and always by comparison with the investment opportunities available in utility stocks, just as the manager of a portfolio of Japanese stocks should be evaluated only in comparison with the Japanese market and not in comparison with the British, Hong Kong, or American markets.

On the other hand, the *policy* of investing in growth stocks (or utility stocks or Japanese stocks) would be critiqued by examining the superiority of portfolios of growth stocks (or utility stocks or Japanese stocks) in comparison with other alternative types of stocks and to the market as a whole, over relatively long periods of time.

All too often, a portfolio manager has been praised or blamed for the favorable or adverse impact of policy over which she or he had no control. And in some cases, the portfolio manager has been credited with "good" performance when, in fact, poor operational performance hindered the attainment of even higher returns that would have resulted from more

carefully following an effective policy.

Just as operating performance can be evaluated against policy, policy can be evaluated against performance. If the portfolio manager does not achieve the intended investment result, should the manager be kept and the policy changed? Perhaps the objective is too high. Perhaps the policy is too restrictive for the objective sought. The point is that we can learn from experience if we reflect thoughtfully on what our experience really means.

From time to time, perhaps once every two or three years, a systematic and comprehensive examination of the client's needs and objectives, market experience, and investment policy would be appropriate. While a review of actual results could be moderately useful in critiquing policy, most of the information relevant to a basic examination of investment policy will come not from the specific portfolio, but from more complete—and more relevant—analyses of major sectors of the investment market over very long periods of time.

If the policy is found inappropriate, it should be changed and the new policy made explicit to the portfolio manager. If the operating performance of the portfolio manager does not con-

form with policy, the manager should be replaced even if such deviation from stated policy resulted in a higher rate of return than would have been earned by following stated policy. (Of course, an incompetent portfolio manager would also be replaced, but this is a far easier decision to make.)

A few simple tests of investment policy are these:

1. Is the policy carefully designed to meet the real needs and objectives of this specific client?
2. Is the policy written so clearly and explicitly that a *competent stranger* could manage the portfolio and conform to the client's intentions?
3. Would the client have been able to sustain commitment to the policies during the capital markets that have actually been experienced over the past 50 or 60 years—particularly over the past 10 years—when conventional wisdom was most opposed?
4. Would the investment manager have been able to maintain fidelity to the policy over the same periods—despite intense daily pressure?
5. Would the policy, if implemented, have achieved the client's objectives?

Sound investment policies will meet *all* of these tests. Do yours?

### Performance Notes:

**Asset Class Returns**—United States: 1-Yr. Bonds = DFA One-Year Fixed Income Portfolio; 5-Yr. Bonds = DFA Five-Year Government Portfolio; Large Stocks = Vanguard 500 Index Fund; Small Stocks = DFA 9-10 Small Company Portfolio; Small Value Stocks = DFA Small Cap Value Portfolio. International: Large Stocks = 57% Vanguard Pacific Index Fund, 43% Vanguard Europe Index Fund (approximates the return of the Morgan Stanley EAFE Index). Japan: Small Stocks = DFA Japanese Small Company Portfolio. Continental Europe: Small Stocks = DFA Continental Small Company Portfolio. United Kingdom: Small Stocks = DFA United Kingdom Small Company Portfolio. Pacific Rim: Small Stocks = DFA Pacific Rim Small Company Portfolio.

**TAM Portfolio Returns Net of Fees**—These are the actual returns of TAM portfolios in each risk category net of actual TAM management fees, custodial fees, and fund expenses. The "Growth" returns were calculated using a model portfolio from 12/31/92 to 3/31/93. In both cases, the maximum TAM fee was deducted, representative custodial costs were deducted, and all mutual fund returns are net of expenses. Past performance is no guarantee of future returns. This is especially the case with model portfolios which are not subject to specific economic or market factors. **Benchmarks**—Balanced Fund & Capital Appreciation Fund Indexes: Lipper Analytical's indexes representing the 30 largest balanced mutual funds and 30 largest capital appreciation mutual funds in the country.