TAM Asset Management Review

Modern Investment Principles For Serious Investors

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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.

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Building Portfolios

Investment Policy: How to Win the Loser's Game
By Charles D. Ellis (Part 10 of 14)

As explained in Chapter 6, we now know that the real challenge in portfolio management is not how to increase *returns*—by buying low and selling high—but how to *manage risk* by deliberately taking appropriate risks that lead predictably over time to increased returns.

The distinctive characteristic of effective portfolio management is the elimination of *unintended* risk associated with individual stocks or groups of stocks and the deliberate assumption of intended market risk.

While it is possible to add value through brilliant stock picking, investments in individual stocks and bonds are best thought of as components to be used in building a well designed portfolio. They may be good components or poor components, but in the context of portfolio management, individual securities have value only to the extent they enable the investment manager to improve the portfolio as a whole by increasing the return or reducing risk or both. Portfolio management is investment engineering.

In line with the concept of portfolio management as a challenge in engineering, the portfolio design that eliminates avoidable and unintended risk and maximizes expected returns at a deliberately chosen level of market risk is an *efficient* portfolio. An efficient portfolio has greater expected return than any other feasible portfolio with equal risk, and less risk than any other feasible portfolio with equal expected return.

Continued on next page...

Asset Class Returns*
Through July 31, 1994

	YTD 1994
United States	
1-Yr. Bonds	+1.3%
5-Yr. Bonds	-1.9%
Large Stocks	-0.3%
Large Value Stocks	-2.9%
Small Stocks	+0.8%
Small Value Stocks	+2.1%
International	
Large Stocks	+10.7%
Japan	
Small Stocks	+41.0%
Continental Europe	
Small Stocks	+16.8%
United Kingdom	
Small Stocks	+6.3%
Pacific Rim	
Small Stocks	-12.3%

All asset classes except Japan Small Stocks moved higher in July. The Continental Europe Small Stock class continues to be driven by the performance of the markets of Italy, Belgium, and the Netherlands.

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

TAM Portfolio Returns Net of Fees*
Through July 31, 1994

Risk (% stocks)	YTD 1994	1993	Since Inception 12/92-7/94
Aggressive (95%)	+7.4%	+21.1%	+30.1%
Growth (85%)	+4.1%	+16.6%	+21.2%
Moderate (65%)	+3.3%	+14.0%	+17.8%
Benchmarks Comparisons			
Balanced Fund Index	-1.5%	+11.7%	+10.0%
Capital Apprec. Index	-5.1%	+14.8%	+8.9%
S&P 500 Stock Index	-0.3%	+10.1%	+9.9%
Salomon Broad Bond Index	-2.9%	+9.9%	+6.8%

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

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Once such an efficient portfolio has been constructed, it would not make sense to incur either individual stock risk or stock group risk unless such available risk were directly associated with—and judged worth taking in order to exploit—a specific opportunity to capture extra return.

The amount by which market risk and return can be magnified in a portfolio by investing in higher market risk—more volatile stocks— is not spectacular, but the benefits, over the very long run, can be worthwhile. A portfolio with a market risk that is 20 percent greater than the overall market average is feasible. A market risk much higher than that would be difficult to design into a portfolio and still have the portfolio well diversified. The number and variety of stocks needed to achieve good diversification and to provide that much market risk simply are not available in the market.

The expected "extra" rate of return for the portfolio with 20 percent more than average market risk would be, on average and over the very long term, 1.4 percent annually.[1] If 1.4 percent of incremental return over the market average return seems modest, remember that no sizable institutional investor has achieved that amount of annual incremental return over any sustained period of time!

Thus far, our discussion has concentrated on equity investments. Portfolio management for bonds is different in the details, but the main concepts are basically the same.

Like stocks, bonds present both individual bond risks and group risks. For example, bonds issued by companies in a particular industry will, as a group, change in value with major changes in that industry's economics. Bonds with particular call or refunding features in common will rise and fall as a group in relative market popularity. The normal difference in yield (and therefore price) between corporate and government bonds changes, causing larger or smaller spreads between corporates as a group and governments as a group.

It is important to note that bond rating agencies have found most of their rating errors caused by the difficulty inherent in estimating such group risks, not in estimating the individual risk of a particular issuer compared to other issuers in the same industry or group.

Bond portfolio management starts conceptually with a passive portfolio that represents the overall bond market. This baseline portfolio will be diversified across numerous issues to protect against the credit risk of individual issuers and will use a defensive, evenly spaced schedule of maturities to defend against adverse changes in interest rates. The overall quality of the portfolio and its average maturity will be set in concert with the client's risk preferences and potential liquidity needs.

As with equities, the historical evidence is that the risk of individual bonds can be substantially eliminated through diversification with the result that portfolios of medium-to-lower-grade issues do, after all actual losses through defaults on either interest or principal or both, provide higher net returns over time than higher-grade issues. Therefore, portfolio managers can increase risk-adjusted return by concentrating on medium-to-lower-grade bonds.

Having established a well-diversified portfolio, the manager and client can then decide whether and how and when to deviate deliberately—if at all—from the "baseline" portfolio in efforts to increase returns by: buying or selling individual issues in anticipation of a recognition by other investors of a change in quality rating; switching from one sector of the market that is currently high in price relative to historical norms to another sector that is relatively low in price; selling an issue that is temporarily high in price (perhaps because of a market imperfection) and simultaneously buying an equivalent issue that is lower in price (the so-called arbitrage swap); or changing the average maturity of the entire portfolio—going for long maturities (and call protection) when interest rates are expected to fall, and shortening up on maturities when interest rates are expected to rise—both to an extent not already anticipated in the market's yield curve.

Even though most investment managers (and their clients) see their work as active, assertive, and offensive, the reality is and should be that portfolio management is primarily a *defensive* process.

In deliberate pursuit of wisely determined and explicitly stated objectives of the client, the purpose of the portfolio manager is to control risk and to limit or prevent surprises. The basic responsibility of portfolio managers, since the invention of insurance and pooled risk accounts in merchant shipping on sailing vessels hundreds of years ago, is to control and manage risk.

[1]Calculated as follows: 120 percent x 7 percent return on equities over and above the 8 percent risk-free rate of return = 1.4 percent.

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 4/30/93. The "Aggressive" 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.