

# TAM ASSET MANAGEMENT REVIEW

Modern Investment Principles  
For Serious Investors

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## The Powerful Plodder

*Investment Policy: How to Win the Loser's Game*, by Charles D. Ellis (Part 5 of 14)

The largest part of any portfolio's total long-term returns will come from the simplest investment decision that can be made, and by far the easiest to implement: buying the market.

Hopelessly unpopular with investment managers and with most clients, the uninspiring, dull "market portfolio" is seldom given anything like the respect it deserves.

Plodding along in its unimaginative, inexpensive, "no brain" way, this "plain Jane" form of investing will, over time, achieve better results than most professional

investment managers.

Active investment managers—particularly those with good records—accept the proposition that the market portfolio achieves good long-term returns, but they see an opportunity and challenge to do better. "Even 1 percent on a \$100 million or \$500 million portfolio is a lot of money—particularly when it's 1 percent compounded year after year—and well worth going after."

They may be right. Some *will* be right. But clients should know that they won't *all* be right. Indeed, the evidence so far is that

a great majority of managers will not. Their clients would have done better in a market fund.<sup>1</sup>

Considering the time, cost, and effort devoted to achieving better than market results, the market fund certainly produces a lot for a little. This dull workhorse portfolio may appear virtually mindless, but is, in fact, based on an extensive body of research about markets and investments that is well worth examining and can be summarized briefly.

To summarize, the securities market is an open, free, and competi-

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Every client of TAM Asset Management receives a copy of Charles D. Ellis' book *Investment Policy*. This book is by far the most useful, objective, and contemporary source on prudent investment strategy I have seen in fifteen years of studying the subject. It is also less than 100 pages long and very easy to read.

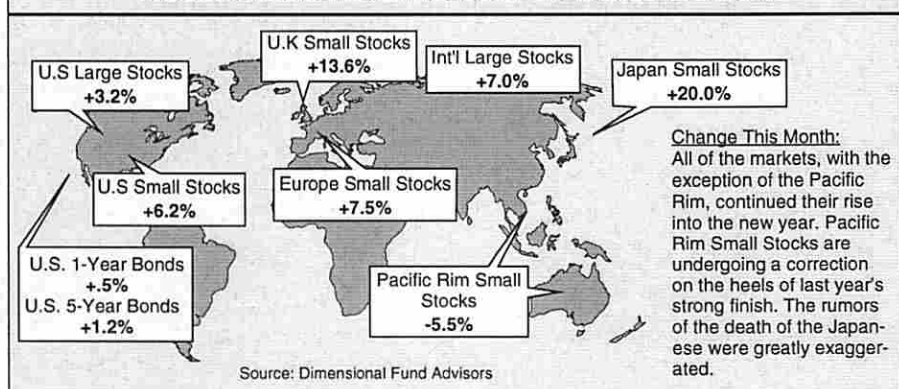
Mr. Ellis is managing partner of Greenwich Associates, the leading consulting firm specializing in financial services worldwide. The author of six books and dozens of articles, he has taught courses at both Yale and Harvard. Ellis earned his B.A. at Yale, an M.B.A. (with distinction) at Harvard and the Ph.D. at New York University.

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Jeff Troutner, TAM Asset Management

<sup>1</sup>One caution is important regarding "market" funds. Significant sectors are left out of the traditional market indexes. Some of the most interesting and rewarding areas of investing in the past decade—particularly small company stocks—are either not included in the index or are under-represented. And all the international markets—more than half of the world market—are not included. To compensate for these gaps, new "extended" market funds are being designed to capture the "whole" market. [Editor's note: Depending on a client's risk profile, TAM invests in market funds for small company stocks as well as for all of the major international markets. We will soon be adding a market fund for "emerging" international markets.]

### Asset Class Returns Year-to-Date: 1/31/94



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tive market in which large numbers of well-informed and price-sensitive investors and professional investment managers compete skillfully, vigorously, and continuously as both buyers and sellers. Nonexperts can easily retain the services of experts. Prices are quoted widely and promptly. Effective prohibitions against market manipulation are established. And arbitrageurs, traders, market technicians, and longer-term "fundamental" investors seek to find and profit from any market imperfections. Such a market is considered "efficient".<sup>2</sup> In an efficient market, changes in prices will follow the pattern described as a "random walk," which means even close observers of the market—"tape readers"—will not be able to find patterns in securities prices with which to predict future price changes on which they can make profits.

Moreover, because other competing investors are well-informed buyers and sellers, particularly when they are considered in the aggregate, it will be unlikely that any one investment manager can regularly obtain profit increments for a large portfolio through fundamental research. The more you believe the market is efficient, the more you will believe the rule that the more numerous the skillful competitors, the less likely anyone will achieve consistently superior results.

In a perfectly efficient market, prices not only reflect any information that could be inferred from the historical sequence of prices, but also incorporate and impound all that is knowable<sup>3</sup> about the companies whose stocks are being traded. An efficient market does not mean that

stocks will always sell at the "right" price. Investors can be quite *wrong* in their judgments—overly optimistic, overly pessimistic—and this will show up in later changes in prices. A market can be quite clumsy on valuations and still be very efficient on market information and on fundamental information about companies. (That's why the best opportunities for active investment management to add value may well come from being wiser and less susceptible to the psychology of the crowd than others.)

The market fund provides investment managers and their clients with an easy alternative. They do not have to play the more complex games of equity investing unless they *want* to play.

This is a marvelous freedom of choice. The option to use the market fund enables any investment manager always to keep pace with the market virtually

without effort. It allows the investor to play only when and where and only for so long as he really wants to—and to select any part of the wide investment spectrum for deliberate action at any time for as long or as brief a period as he wishes.

Even for the most self-assured and capable investment managers, the ability to call "time out" and to invest at any time in a market fund is an important advantage because superior knowledge and skill are not consistent attributes of investment managers. Superior knowledge is a *variable*. This freedom not to play carries the reciprocal responsibility to play only for cause, and only when the incremental reward fully justifies the incremental risk.

Investment managers and their clients would be wise to devote more attention to understanding the real advantages offered by the market fund—the powerful plodder.

<sup>2</sup>Not perfect, and not even perfectly efficient, but sufficiently efficient that wise investors will not expect to be able to exploit its inefficiencies regularly.

<sup>3</sup>While there is some specialized evidence that quarterly earnings reports and information on "insider transactions" are not immediately and completely discounted in securities prices the apparent opportunities to be exploited are so very limited that managers of large portfolios would not be able to make effective use of this kind of information anyway.

### **Fundamental Changes Contributing to an "Efficient" Market:**

- Professional investors now account for 80% of all stock trades
- There are now 18,000 registered advisors (3,000 in 1970)
- There are now over 4,400 actively-managed mutual funds

These changes accelerated over just the past ten years and are having a significant effect on the after-fee performance of active money managers. The implication of these changes—that long-term investors would be better off in appropriately balanced *asset class* portfolios rather than chasing hot managers or mutual funds—is a significant threat to most stockbrokers, managers, manager consultants, and the mutual fund families who sell "superior" performance. As a result, don't look for these groups to promote the principles of indexing anytime soon (with the very notable exception of the Vanguard Group of mutual funds).