

# TAM ASSET MANAGEMENT REVIEW

Facts & figures on global investment strategies

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## The Loser's Game

*Investment Policy: How to Win the Loser's Game, by Charles D. Ellis (Part 3 of 14)*

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," that is, to beat the market. 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 pension funds, endowments, and the personal assets of most individual investors because these 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 man-

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ager 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

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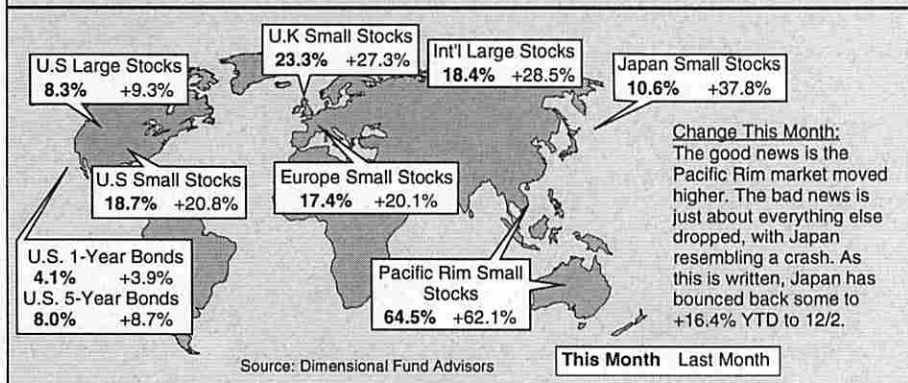
Every client of TAM Asset Management receives a copy of Charles D. Ellis' book *Investment Policy*. This book is by far the most useful, objective, and contemporary source on prudent investment strategy I have seen in fifteen years of studying the subject. It is also less than 100 pages long and very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

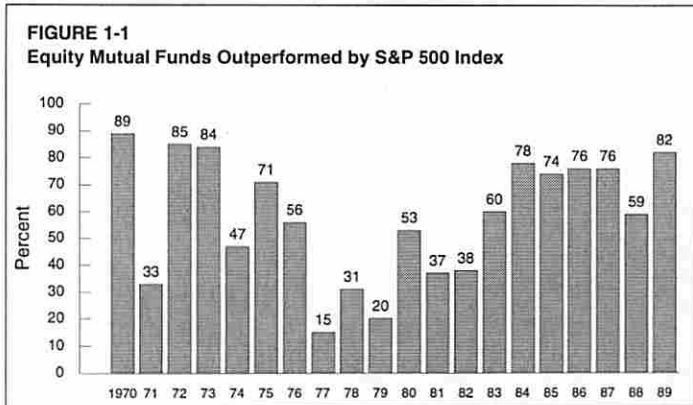
### Asset Class Returns Year-to-Date: 11/30/93



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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. See Figure 1-1.



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*<sup>1</sup>. 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 different.

After extensive scientific and statistical analysis, Dr. Ramo summed it up this way: Professionals *win* points; amateurs *lose* points.

In expert tennis, the ultimate outcome is determined by the

actions of the winner. Professional tennis players stroke the ball with strong, well-aimed shots, through long and often exciting rallies, until one player is able to force an error by his opponent or drive the ball just out of reach. These splendid players seldom make mistakes.

Amateur tennis, Dr. Ramo found, is almost entirely different. Brilliant shots, long and exciting rallies, and seemingly miraculous recoveries are few and far between. On the other hand, the ball is fairly often hit into the net or out of bounds, and double faults at service are not uncommon. The amateur duffer seldom beats his *opponent*, but he beats *himself* all the time. The victor in this game of tennis gets a higher score *because his opponent is losing even more points*.

As a scientist and statistician, Dr. Ramo gathered data to test his hypothesis in a clever way. Instead of keeping conventional game scores—love, 15 all, 30-15, and so forth—Ramo simply counted points won versus points lost. He found that in expert tennis about 80 percent of the points are won, but in amateur tennis about 80 percent of the points are lost.

The two games are, in their fundamental characteristic, opposites. Professional tennis is a winner's game whose outcome is determined by the activities of the winner. In amateur tennis, the final outcome is determined by the activities of the loser—who defeats himself. It's a loser's game.

Switching from tennis to military science, Admiral Samuel Elliot Morison makes a similar central point in his thoughtful treatise *Strategy and Compromise*: "In warfare, mistakes are inevitable. Military decisions are based on estimates of the enemy's strengths and intentions that are usually faulty, and on intelligence that is never complete and often misleading." (Doesn't this sound like investment management?) "Other things being equal," concludes Morison, "the side that makes the fewest strategic errors wins the war."<sup>2</sup>

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War is the ultimate loser's game. Golf is another. Tommy Armour, in his great book *How to Play Your Best Golf All the Time*, says: "The best way to win is by making fewer bad shots,"<sup>3</sup> an observation with which all weekend golfers would concur. There are many other loser's games. Some, like institutional investing, were once winner's games, but have changed into loser's games with the passage of time. For example, 60 or 70 years ago only very brave, athletic, strong-willed young people with good eyesight had the nerve to

*Continued on next page...*

<sup>1</sup>Simon Ramo, *Extraordinary Tennis for the Ordinary Tennis Player* (New York: Crown Publishers, 1977).

<sup>2</sup>Samuel Elliot Morison, *Strategy and Compromise* (New York: Little Brown, 1958).

<sup>3</sup>Tommy Armour, *How to Play Your Best Golf All the Time* (New York: Simon & Schuster, 1971).

try flying an airplane. In those glorious days, flying was a winner's game. But times have changed and so has flying. If the pilot of your 747 came aboard today wearing a 50-mission hat with a long, white silk scarf around his neck, you'd get off. Such people no longer belong in airplanes because flying today is a loser's game with one simple rule: Don't make mistakes.

These examples should suffice to prove that the requisite player strategy is very different for the two kinds of games and to show that winner's games can and sometimes do become loser's games.<sup>4</sup> That is what has happened to the "money game" we call investment management.

A basic change has occurred in the investment environment; the market came to be dominated in the 1970s by the very institutions that were striving to win by outperforming the market. In just 10 years, the market activities of the investing institutions shifted from only 30 percent of total public transactions to an overwhelming 80 percent. And that shift made all the difference. No longer was the active investment manager competing with cautious custodians or amateurs who were out of touch with the market: Now he was competing with other experts.

The money game includes a formidable group of competitors. At least 200 major institutional investors and another 1,000 small- and medium-sized institutions operate in the market all day, every day, in the most intensely competitive way.

The key question under the new rules of the game is this: How much better must the active manager be to *at least* recover the costs of active management? The answer is daunting. If we assume 30 percent portfolio turnover (which is lower than the institutional average) and total transaction costs (commission plus the spread between the bid and the ask side of the market including occasions when large blocks of stock

are being bought or sold in distress) of 2 percent to buy and 2 percent to sell (certainly not high estimates), plus a fee for active management of 0.4 percent (which is increasingly "normal"), the actively managed portfolio's operating costs are 1.6 percent per annum<sup>5</sup>.

Recovering these costs is surprisingly difficult. For example, assuming an average annual rate of return of 15 percent for equities, of which 6 percent is the equity premium return (i.e., about the way it has been for the past 50 years), then the active manager must recover the 1.6 percent annual operating costs by increasing the 6 percent equity premium return by more than 25 percent.<sup>6</sup>

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Such superior performance can be done and is done every year by some institutions, but it has not been done consistently over a long period of time by many.

The stark reality is that most money managers have been losing the money game. The historical record is that in the 20 years ending with 1990, on a cumulative basis, over three quarters of professionally managed funds underperformed the S&P 500 Market Stock Average.

That being true, the burden of proof is on the person who says, "I am a winner, I can win the money game." Because only a sucker backs a false "winner" in a loser's game, prospec-

tive clients have a right to demand that the investment manager explain exactly what he or she is going to do and why it is going to work so very well.

If investment managers are on balance not beating the market, then they certainly should at least consider joining it. The data from the performance measurement firms suggest that a market fund (i.e., an index fund) would have outperformed most investment managers over long periods of time.

The reason that institutional investing has become a loser's game is that in the complex problem each manager is trying to solve, his efforts, and the efforts of his many determined competitors, to find a solution have become the dominant variables. And their efforts to beat the market are no longer the most important part of the solution; they are the most important part of the problem. So many professional investment managers are so good, they make it nearly impossible for any one to outperform the market they now dominate.

The beginning of wisdom for clients of investment managers is to understand why so few—if any—major investment organizations can or will outperform the market averages over long periods of time and how very difficult it is to estimate which managers will outperform.

The next step would be to decide whether—even if it could be won—this loser's game is a game worth playing.

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<sup>4</sup>Perhaps winners' games self-destruct because they attract too many players—all of whom want to win. (That's why gold rushes finish ugly.)

<sup>5</sup>(0.4 percent + .3 x [2 percent + 2 percent]). Far more than brokerage commissions and dealer spreads are properly included in transactions costs. The best way to show how large transactions costs really are is to compare the theoretical results of a "paper portfolio" with the actual results of a "real money portfolio." Experts will tell you the differences are always impressive. And there's yet another cost of transactions—the cost of unwisely getting into stocks you would not have attempted if you were not "sure" you could get out at any time because the market looks so liquid. This is a real liquidity trap. Think how differently people would behave on the highway or in the bedroom if they were not so sure they'd not be caught. It's the same way in investments: you don't always get caught nor do you always not get caught. All of these costs are part of the total transactions costs.

<sup>6</sup>26.7 percent to be exact.

# Retirement Plan Fiduciaries Might Pay A High Price For Playing the Loser's Game

By Jeff Troutner

This is a gloomy subject that many plan sponsors, trustees, and investment advisors would just as soon not be reminded of. But in the age of ambulance chasers it doesn't take much of a stretch to believe that thousands of these fiduciaries are vulnerable to major lawsuits down the road. The huge number of white-collar layoffs and early retirements will focus the spotlight on the inadequate benefits coming out of retirement plans, particularly 401(k) plans.

Whose fault will it be? The employee's for improperly allocating the assets among the different investment options? Or for jumping in and out of the various mutual funds based on what he read in *Money* magazine or heard at the drinking fountain? Or for directing the bulk of the assets to be placed in GIC's and other fixed-income investments?

Or will it be shown that the employer is at fault for these mistakes by not providing sufficient initial and on-going investment education? Or for failing to offer the best investment options, chasing hot funds or money managers, or relying too heavily on retail brokers for "consulting services".

Where do fees and expenses come in? The updated Prudent Investor Rule, which governs the investment of trust assets, sheds significant light on the sensibility of modern portfolio practices that use low-cost index funds, and it in many ways questions the costs and risks of traditional management techniques. Since these new guidelines were published only three years ago, many plan fiduciaries are not aware of

them or have chosen to go on with business as usual. You can bet, however, that there are attorneys just waiting for the opportunity to try them out in court.

How can plan fiduciaries protect themselves from this potential liability? The first step is to read and understand the principles of the Restatement of the Law Third: Trusts (The Prudent Investor Rule). The text can be obtained from The American Law Institute.

research against active management is so overwhelming that you may not have a leg to stand on.

(By the way, stockpicking and market timing strategies will not disappear as fiduciaries become more aware of their shortcomings. They will continue to be used by individuals and non-ERISA investors who are willing to pay the higher fees and take on the additional risk for the *hope* of higher-than-market returns).

Third, you should make sure that your participants or the corporate officers in charge of selecting the investments for the plan are properly educated on *modern portfolio principles*. Limiting the portfolio to *traditional* U.S.-only balanced, bond, or equity management in view of today's research supporting much greater diversification, might not be a safe haven. Asset allocation is the most important decision, but again, the best asset mix in the world can be offset by lack of diversification, bad stock picks, or bad market timing by the manager. The use of index funds eliminate these elements of risk.

Fourth, you should expect your investment advisor to communicate regularly with you and your employees in order to reinforce the principles and maintain the long-term discipline required to be successful.

If active managers are being used, the advisor should be prepared to demonstrate value-added *after fees*. Don't buy the line about a consultant's ability to select "superior" managers the *next* time around. Blame can only reach so far and the attorneys know where to fix it.

Finally, always have a written Investment Policy and follow it.

## Whose Fault Will It Be When...



The employee chooses the wrong mutual funds...



The employee switches in and out of funds rather than staying with a long-term plan...



The employee is overwhelmed and parks the money in the money market fund...

Or the employer:

- directs the investments and hires inferior managers
- allows the plan to incur high costs without value-added
- fails to diversify properly
- invests too "conservatively"?



The next step is to seriously evaluate your current program to determine whether the managers or mutual funds you have in place have shown added value over a comparable unmanaged index over the past three to five years. Even then, the body of