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US Strategy

Pressing On, Regardless

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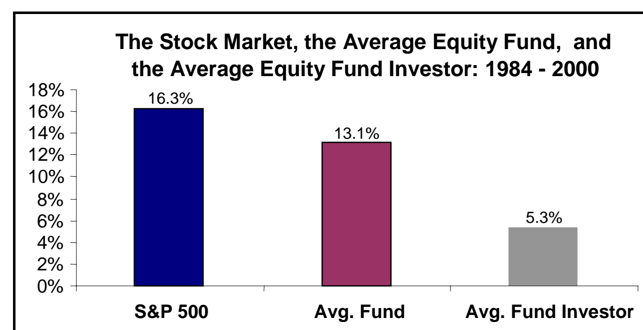
For the past four years I have taught the Securities Analysis class to MBA candidates up at Columbia University. In addition to spending time on the basics of stock analysis, the class typically also features prominent investors discussing their approaches to investing and markets. Last week, in what may have proved the academic equivalent of inviting the president of the temperance league to lecture a class on bartending, I invited Jack Bogle to address the class. Thankfully, it was past the midpoint of the semester and refunds were no longer allowed. I say this not because Bogle's message was muddled, but rather the opposite — it was analytically airtight. Armed with data and facts, he laid out the case against active management and for indexing quite powerfully. My guess is that more than a few students left the class wondering just what the heck their hard-earned tuition dollars were doing going to a class devoted to the seemingly impossible — analyzing securities to achieve better-than-market returns.

At least the students have the excuse of being early in their careers; what's mine for staying the course in my current role? For the most part I subscribe to many of Bogle's core themes — low turnover and low cost most prominent among them. Indeed, for many investors an index product is the most appropriate vehicle with which to build a core investment holding. This said, exceptional individuals have, however rarely, been able to post exceptional investment results. Heck, even Vanguard carries active portfolios in its arsenal of product. In fact, proving the apple may stray a bit from the tree, Jack's son is an active money manager. Still, we recognize that the odds are against active managers. As such, we continue to approach our strategy product with a sober eye, encouraging investors to take outsized positions only when investment anomalies have become so extreme that the weight of evidence is squarely on their side. Almost without exception, such opportunities arise only when they are least likely to be embraced by the consensus and feel most unpleasant to consider (e.g., a value-over-growth bet two years ago).

The state of the State (such as it is). Following one of the most robust bull markets of any era, the question remains as to how much investment return ultimately stuck with investors at the end. We know what the various indexes have done over the past 20 years, but historically investors, in aggregate, achieve something less than the index return (given fees, taxes, commissions, etc.). Various researchers (Odean and Barber, Dalbar, Leuthold et al.) have explored this topic, and each has concluded the same thing to varying degrees: Investors' returns in this wonderful investment era have ranged from the subprime to the ridiculous (Exhibit 1). Bogle's view was blunt: If mutual fund investors can only derive single-digit returns in a mid-teens return environment, prospects are apt to be all the more frustrating in an era of lower financial returns.

Exhibit 1
An Undemocratic Bull Market?



Source: Bogle Financial Center. Average annual return.

The first shall be last (and sometimes, the last first). So how on earth could so much raw investment return translate into so little shareholder return? In a nutshell, performance chasing. With, at times, over 100% of all mutual fund flows going into Morningstar four- or five-star rated funds, individual investors have become integral players in the momentum-driven markets of the past decade. Ironically, if there is one line from the marketing literature of money management that needs to be changed, it is the one that states "past performance is no guarantee of future returns."

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As Bogle pointed out, in fact, one of the things an investor can most count on with respect to a guarantee of future returns is that subpar returns will subsequently follow tremendous investment results. On the flip side, with somewhat less frequency (given fund mortality rates), robust results will follow subpar returns (Exhibits 2 and 3).

Exhibit 2
The First Shall Be Last…

Reversion to the Mean in Fund Performance
The First Shall Be Last…

1998-99		2000-2001	
Rank	**Ann.Ret.**	**Rank**	**Ann.Ret**
1	208%	1413	-71%
2	115%	1408	-49%
3	105%	1406	-43%
4	93%	1401	-36%
5	93%	1395	-34%
6	92%	1402	-37%
7	90%	1341	-26%
8	87%	1309	-24%
9	84%	1370	-29%
10	79%	1347	-27%

Exhibit 3
...and the Last...

Reversion to the Mean in Fund Performance
The Last Shall Be First…

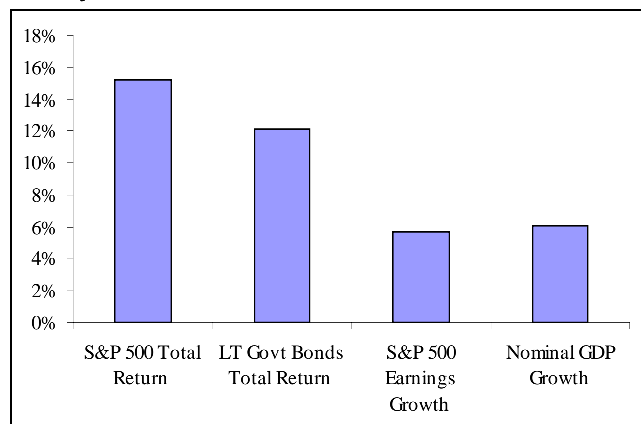
1998-99		2000-2001	
Rank	**Ann.Ret.**	**Rank**	**Ann.Ret**
1,404	-8%	95	16%
1,405	-9%	129	14%
1,406	-9%	65	19%
1,407	-9%	52	21%
1,408	-9%	174	10%
1,409	-10%	66	19%
1,410	-11%	123	15%
1,411	-12%	329	3%
1,412	-16%	92	17%
1,413	-29%	76	18%

Source: Bogle Financial Center - 1,413 funds with $100 million+ in assets

Single-digit returns ahead. Last week (see *Reaching for Stars, Grasping Straws*), we noted that both institutional and individual investors needed to ratchet down return expectations. Although the last two years have been quite poor, investors cling to expectations of long-term double-digit returns in the years ahead. In the context of the past two decades, double-digit returns in the high teens may seem reasonable, but a blunt review of economic history suggests they may, in fact, prove quite difficult to achieve. Given the starting dividend yield and P/E ratios for the market, Bogle suggested (a stance we agree with) that 7–8% returns off of today's base would be realistic. Consistent with this point, we continue to believe portfolio managers should explicitly not be making P/E multiple expansion bets today. Instead, we believe investors need to focus on those few companies that can genuinely increase earnings at a double-digit clip and where the current P/E multiple can hold (select healthcare, retailers, media, and financials). Or, alternatively, scout out those firms with cyclically depressed earnings where earnings may rise several hundred percent while the multiple declines (basic materials, industrials, parts of energy).

Which way is the wind blowing? Finally, as we have noted in the past (see *Losing the Winner's Game,* February 6), it is difficult to imagine a more favorable macro environment for the money management business than that of the past two decades. Clearly, the wind has been at the industry's back. A firm merely holding market share and appreciating with the growth in stocks and bonds would have grown at almost three times the clip of S&P earnings or nominal GDP (Exhibit 4). Financial assets are unlikely to continue accumulating at this pace, however, and our guess is market share gains will be a far larger component of industry success in years ahead. As always, performance will be a prime contributor to share gains, and low cost seems to be a constant across most truly successful fund complexes.

Exhibit 4
Twenty Years of Wind at the Back



Source: Ibbotson Associates, Standard & Poor's, BEA; data for 1981–2001

On his second heart and third career, Jack Bogle is still full of fire and brimstone. His message remains relatively short on opinion (though quite pointed) but long on fact. Today, that message is fairly sobering. Equity market returns of the next decade are likely to be lower than those of the prior two. In such an environment, investors need, perhaps more than ever, to be cognizant of costs. One hundred fifty basis points in costs on a return of sixteen percent may seem

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trivial, but on eight percent the hit is quite noticeable. From our perspective, perhaps in a triumph of hope over experience, we continue to believe active managers can add value. To do so, however, we suspect investors must be truly active: Don't confuse trading activity with progress, but rather break free of some of the benchmarking shackles that have come to dominate parts of the industry today.

V = More volatile. We estimate that this stock has more than a 25% chance of a price move (up or down) of more than 25% in a month, based on a quantitative assessment of historical data, or in the analyst's view, it is likely to become materially more volatile over the next 1-12 months compared with the past three years. Stocks with less than one year of trading history are automatically rated as more volatile (unless otherwise noted). We note that securities that we do not currently consider "volatile" can still perform in that manner.

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