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PERSPECTIVES

The Winners' Game

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Everyone likes to succeed in investing. Millions of investors depend on investment success to assure their security in retirement, to provide for their children's education, or to enjoy better lives. Schools, hospitals, museums, and colleges depend on successful investing to fulfill their important missions. As investment professionals, when the services we offer help investors achieve their realistic long-term objectives, ours can be a noble profession.

The accumulating evidence, however, compels recognition that investors are suffering serious shortfalls. Part of the problem is that investors make mistakes. But they are not alone. As investment professionals, we need to recognize that much of the real fault lies not with our clients but with ourselves—the unhappy consequence of three major systemic errors. Fortunately, we can—and so should—make changes to help ensure investing is, both for our client investors and for ourselves, truly a winners' game.

For all its amazing complexity, the field of investment management really has only two major parts. One is the *profession*—doing what is best for investment clients—and the other is the *business*—doing what is best for investment managers. As in other professions, such as law, medicine, architecture, and management consulting, there is a continuing struggle between the *values* of the profession and the *economics* of the business. We must be successful at both to retain the trust of our clients and to maintain a viable business, and in the long run, the latter depends on the former. Today, investment management differs from many other professions in one most unfortunate way: We are losing the struggle to put our professional values and responsibilities first and our business objectives second.

We can stop losing the struggle if we redefine our mission to emphasize the investment counseling values of our profession—and our understanding of investors and investing—to help clients focus on playing the investment game that they can win *and* that is worth winning. Fortunately, what is good for our professional fulfillment can, in the long run, be good for business.

While the investment profession, like all learned professions, has many unusually difficult aspects that require great skill and is getting more complex almost daily, it too has just two major parts. One part is the increasingly difficult task of somehow combining imaginative research and astute portfolio management to achieve superior investment results by outsmarting the increasingly numerous professional investors who now dominate the markets and collectively set the prices of securities. Always interesting, often fascinating, and sometimes exhilarating, the work of competing to "beat the market" has been getting harder and harder and has now become extraordinarily difficult. Most investors are not beating the market; the market is beating them.

Difficulty is not always proportional to importance. In medicine, simply washing one's hands has proven to be second only to penicillin in saving lives. Fortunately, the most valuable part of what investment professionals do is the least difficult: investment counseling. As experienced professionals, we can help each client think through and determine the sensible investment program most likely to achieve his or her own realistic long-term objectives within his or her own tolerance for various risks—variations in income, changes in the market value of assets, or constraints on liquidity. Then, we can help each client stay with that sensible investment program, particularly when markets seem full of exciting, "this time it's different" opportunities or fraught with disconcerting threats.[1] Success in this work is not simple or easy but is much easier than success in investment management, and with the new tools available to investment professionals,[2] it is getting easier even as performance investing is getting steadily harder.

Three Errors

With remarkable irony, those of us devoting our careers to investment management have unintentionally created for ourselves three problems. Two are errors of commission with increasingly serious

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consequences. The third is an even graver error of omission. Unless we change our ways, this troika of errors will harm the profession that has been so intellectually and financially rewarding to so many of us. Let me first explain each error in turn and then propose the best solution.

Error 1. Falsely Defining Our Mission. The first error is that we have falsely defined our professional mission to our clients and prospective clients as "beating the market." Fifty years ago, those taking up that definition of mission had reasonable prospects of success. But those years are long gone. In today's intensively competitive security markets, few active managers outperform the market by even 1 percent over the long term, most managers fall short, and in terms of magnitude, *under*performance substantially exceeds *out*performance. In addition, identifying the few managers who will be the future "winners" is notoriously difficult,[3] and the rate of subsequent failure among one-time "market leaders" is high.[4]

Truly massive changes have transformed the markets and investment management so greatly that for most investors, beating the market is no longer a realistic objective, as more and more of us are recognizing. Here are some of the changes that over 50 years have compounded to convert active investing into a loser's game:

- NYSE trading volume is up over 2,000 times—from about 2 million shares a day to about 4 billion. Other major exchanges around the world have seen comparable changes in volume.
- The mix of investors has changed profoundly—from 90 percent of total NYSE listed "public" trading being done by individuals to 90 percent being done by institutions. And anyone with a long memory will tell you that today's institutions are far bigger, smarter, tougher, and faster than those of yore.
- Concentration is extraordinary: The 50 most active institutions do 50 percent of all NYSE listed stock trading, and the smallest of these 50 giants spends $100 million annually in fees and commissions buying services from the global securities industry. Naturally, these institutions get the "first call."
- Derivatives have gone in value traded from nil to larger than the cash market.
- Nearly 100,000 analysts—up from zero 50 years ago—have earned CFA charters and another 200,000 are candidates, led by those in North America, China, and India.
- Regulation Fair Disclosure, commonly known as Reg FD, has "commoditized" most investment information now coming from corporations.
- Algorithmic trading, computer models, and numerous inventive quants are all powerful market participants.
- Globalization, hedge funds, and private equity funds have all become major forces for change in the security markets' competitive intensity.
- Bloomberg, the internet, e-mail, and so forth have created a technological revolution in global communications. We really are "all in this together."
- Investment research reports from major securities firms in all the major markets around the world produce an enormous volume of useful information that gets distributed almost instantly via the internet to tens of thousands of analysts and portfolio managers around the world who work in fast-response decision-making organizations.

As a result of these and many other changes, the stock markets—the world's largest and most active "prediction markets"—have become increasingly efficient. So, it is harder and harder to beat the smart, hard-working professionals—with all their information, computing power, and experience—who set those market prices. And it's much, much harder to beat the market after costs and fees. That is why, among mutual funds, the approximate proportion, net of fees, typically falling behind the market averages has become 60 percent in any 1 year, 70 percent over 10 years, and 80 percent over 20 years.[5]

Sadly, most descriptions of "performance" do not even mention the most important aspect of all investing: risk. So, it is important to recall that the "losers" underperform the market by twice as much as the "winners" outperform.[6] Nor do the data adjust for taxes, particularly the high taxes on short-term gains that come with the now normal 100 percent portfolio turnover.[7] Finally, of course, performance for funds is usually reported as *time* weighted, not *value* weighted, so the reported data do not show true investor experience. That can only be shown with the value-weighted record of how real investors fare with their real money. This is not a pretty picture.

Nor is it comforting to see the details of how clients—both individuals and institutions—turn negative toward their investment managers after a few years of underperformance and switch to managers with a "hot" recent record, positioning themselves for another round of buy-high, sell-low dissatisfaction and obliterating roughly one-third of their funds' actual long-term returns.[8] (Individuals who actively manage their own investments, notoriously, do even worse.)[9] Unfortunately, this costly behavior is encouraged by investment firms that, to increase sales, concentrate their advertising on funds selected clearly because their recent results—over selected time periods—make good results look even "better." And some fund managers have several hundred different funds, apparently so that they will always have at least some "documented winners."

In hiring new managers, individual investors notoriously rely on past performance even though studies of mutual funds show that for 9 out of 10 deciles of past performance, future performance is virtually random. (Only one decile's past results have predictive power: the worst or 10th decile—apparently because only high fees and chronic incompetence have a reliably repetitive impact on a manager's results.) The sad result is that investors—both institutional and individual—time and again buy after the best results and sell out after the worst is over. Although 83 percent of plan sponsor investment committees rate themselves "above average" on investment expertise, ironically, the average managers they fire actually achieve slightly higher returns over the next few years than the average managers they hire.[10] And the investment products that institutions move out of proceed to outperform the products they move into.[11] This behavior is costly.

Clients may well ask, "How can this be? Didn't our consultants' presentation show that the managers they recommend usually outperform their benchmarks? So shouldn't their managers be earning *something* above the market even after fully adjusting for risk?" Unfortunately for those holding this hopeful view, the data usually shown by many consultants are flawed. By simply removing two biases in the "data" as conventionally presented—backdating and survivor bias—the apparent record on managers monitored by consultants often shifts down from "better-than-the-market" appearances to "below-the-market" realities.[12] Even large and sophisticated institutions should know who is watching the watchmen.

The grim reality of our first error of commission is that we continue selling what most of us have not delivered and, realistically, will not deliver: beat-the-market investment performance. Most investors have not yet caught on to the fact that they would be better off if they put most of, if not all, their investments in low-cost index funds or index-matching exchange-traded funds, but that is not the strong "protective moat" against competition that Warren Buffett looks for in a business. One reason investors have not caught on is a major misunderstanding regarding fees.

■ *The Reality of Fees.* Most investors still do not realize that investment management fees are *not* low.[13] Fees are actually very high when seen for what they really are. A fee of 0.5 percent—when measured as a percentage of the client's own *assets*—is surely more than 5 percent of the client's probable average annual *returns*.[14] Because investors can get virtually guaranteed market returns through index funds for less than 10 bps, what they really "buy" when retaining active managers is risk-adjusted *incremental* returns. Calibrated as a percentage of risk-adjusted incremental returns, investment management fees are *not* low; they are high. After 50 years of fee increases, overall investment management fees are now greater than the risk-adjusted incremental returns. This means that investment managers now charge clients more than 100 percent of the benefits actually produced. This stark reality is surely one strong reason for redefining our professional proposition to our clients with due deliberate speed.

■ *Our Best Opportunity.* When they have earned the trust and confidence of their clients, investment counselors can add far more to clients' long-term returns than portfolio managers can hope to produce. This is not a "snap" solution: Effective investment counseling takes time, knowledge of the complexities of markets, investing, and investors, and hard work. But it can be done and can be repeatedly done well. Successful counselors will help each client understand the risks of investing, set realistic investment objectives, be realistic about saving and spending, select the appropriate asset classes, allocate their assets appropriately, and most importantly, not overreact to market highs or lows. Counselors can help their clients stay the course and maintain a long-term perspective by helping them understand what managers are intending to achieve over the long term, understand the predictably disconcerting market turbulence, and be confident that reasonable long-term investment results will reward their patience and fortitude.

Error 2. Incorrectly Ordering Our Priorities. Our second error of commission is that we have allowed the values of our profession to become increasingly dominated by the economics of our business. This may be most evident on a personal level. We should candidly ask ourselves, Who would deny the obvious delights of affluence? Our crowd, compared with 50 years ago, live in nicer homes, drive fancier cars, take more interesting vacations, and decorate our larger homes and offices with more remarkable paintings and sculptures. Private planes and "name-it-for-me" philanthropy are not unknown. Realistically, the biggest challenge in our personal finances is not how to get out of debt and pay for our kids' college; it is how to avoid ruining our children's lives by failing to impart the right values for them to achieve success in their own right and by giving them too much too soon.

It is at least possible that the talented and competitive people attracted to investment management have, however unintentionally, gotten so caught up in competing for the tangible prizes that they are not asking potentially disruptive questions about the real value of their best efforts—particularly when they know they are unusually capable and are working terribly hard. Consider the main ways the profitability of investment management has increased over the past 50 years:

- Assets managed, with only occasional short pauses, have risen tenfold.
- Fees as a percentage of assets have multiplied more than five times.

The combination has proven powerful. As a result of strongly increasing profitability,

- individual compensation has increased nearly tenfold, and
- enterprise values are way, way up.

A Great Business. As a result of the investment management business having wide profit margins, modest capital requirements, minimal business risk, and virtually assured long-term growth, investment management organizations have become prime acquisition targets for giant noninvestment financial service organizations, such as banks, insurers, and securities dealers.[15] When they choose to remain independent, some firms go public whereas others stay private, but they all recognize the reality that they have become big businesses and thus manage themselves appropriately.

As investment management organizations have been getting larger, it is not surprising that business managers have increasingly displaced investment professionals in senior leadership positions or that business disciplines have increasingly dominated the old professional disciplines. Business disciplines focus the attention of those with strong career ambitions on increasing profits, which is best achieved by increased "asset gathering"—even though investment professionals know that expanding assets usually works against investment performance. In the view of senior executives of large financial service conglomerates whose judgments of division-by-division results are understandably profit focused rather than investment focused, business success will be determined by the consistency of and rate of increase in reported profits. And the bigger the business, the more likely it is that the focus of senior management will be on increasing business profits.

Investing as a Business. Investment professionals searching for long-term value know that intense attention must be paid to current market prices, which are always changing and often turbulent. But for the financially focused owners of investment firms, the long-term trends of the investment business offer a very different perspective. Of course, markets fluctuate, sometimes sharply and sometimes substantially, but diversification across asset classes—taking a lesson from portfolio management—reduces the range and frequency of profit fluctuations for a well-managed investment business. More important, the long-term upward trend of all investment markets is strongly favorable, so an astute business manager will realize that profitability is diversified over many time periods. Even within a single decade, the owner of an investment business can absorb market fluctuations and focus on long-term business trends.

The basic trend of nominal market value is clearly upward—at over 5 percent compounded or more than twice the rate of the overall economy. Add to this the positive impact of incremental sales to current clients and the benefits of entering new markets with established products and developing new products for sale to established clients, and the annually compounding upward trend rises above 10 percent. A service business that can grow at 10 percent, requires almost no capital at risk, and can expand extensively while enjoying wide profit margins is, as Mae West so wisely appreciated, "Wunnerful!" In a situation like this, even though investment professionals know from experience that asset size is the enemy, what would any red-blooded business manager do? Would he not recognize the high margins on incremental assets and drive to gather assets, build the business, and sell what is selling?

At investment organizations around the world, the two most important internal changes have not been in investment research or in portfolio management. They have been in new business development (to *get* more business when performance is favorable) and in relationship management (to *keep* more business longer—particularly when performance is not favorable). These changes respond primarily to the realities of the business as a business, not to the needs of the profession as a profession—nor to the needs of our clients as investors.

When business dominates, it is not the friend of the investment profession. If and when, as so very often happens, successful asset gathering eventually overburdens an organization's professional capacities for superior investing, results achieved for investors will fade. In addition, actions aiming to increase an organization's results as a business, such as cost controls, fee increases, and drives for greater "productivity," increase the chances that the organization's professional results will suffer.

Error 3. Dropping Rigorous Counseling. Our third error—an error of omission—is particularly troubling for all of us who want our work to be recognized as a valuable professional service. In addition to the two errors of commission—accepting the increasingly improbable prospect of beat-the-market performance as the best measure of our profession and focusing more and more attention on business achievements rather than on professional success—we have somehow lost sight of our best professional opportunity to serve our clients well and shifted our focus away from effective investment counseling.[16] While the largest institutional funds with expert staffs are surely able to take on all their responsibilities without assistance from professionals with training and experience in the complexities of working out the architecture of an optimal long-term investment program, most investors—particularly individuals, but also most investment committees at small and midsize public pension funds, corporate retirement funds, and the endowments of colleges, universities, museums, and hospitals—are understandably not experts on contemporary investing and may not have broad experience. Many need help. All would appreciate having access to the best professional thinking and judgment.

■ *We Can Help.* Investment professionals are well positioned to provide important help. Some of the help clients need is in understanding that selecting managers who will actually beat the market over the long term is no longer a realistic assumption or a "given." (Yes, some managers will succeed, but discovering which ones *in advance* has become exceedingly difficult.) Investors also need help in understanding that losses from trying harder exceed gains. Far more important, they need help to gain a realistic understanding of the long-term and intermediate prospects for different kinds of investments—risk and volatility first, rate of return second—so they will know what to expect and how to determine their strategic portfolios and investment policies.

Still more important, as already noted, most investors need help in developing a balanced, objective understanding of themselves and their situation: their investment knowledge and skills; their tolerance for risk in assets, incomes, and liquidity; their financial and psychological needs; their financial resources; their financial aspirations and obligations in the short and long run; and so forth. Investors need to know that the problem they most want to address and solve is not beating the market. It is the combination of these other factors that creates their own reality as investors.

Although all investors are the same in several ways, they are very different in many more ways. All investors are the same in that they all have many choices and are free to choose, their choices matter, and they all want to do well and want to avoid doing harm. At the same time, all investors differ in very many ways: assets, income, spending obligations and expectations, investment time horizon, investment skills, risk and uncertainty tolerance, market experience, and financial responsibilities. With all these differences, investors (both individuals and institutions) need help in designing investment programs that are really well suited to themselves as investors—both strengths and weaknesses. What is right for most investors is importantly different from a lemming-like struggle to beat the market.

Skiing provides a useful analogy. At Vail and Aspen in Colorado, as well as at other great ski resorts, thousands of skiers are each enjoying happy days, partly because the scenery is beautiful, partly because the snow is plentiful and the slopes are well groomed, but primarily because each skier has chosen the well-marked trails that are best suited to his or her skills, strength, and interests. Some like gentle "bunny slopes," some like moderately challenging intermediate slopes, some are more advanced, and still others want to try out trails that are challenging even for fearless experts in their late teens with spring-steel legs. When each skier is on the trail that is right for her or him and skiing that trail at the pace that is right for her or him, everyone has a great day and all are winners.

■ *We Should Help.* Similarly, if investment professionals were to guide investors to investment programs that are right for their investing skills and experience, their financial situations, and their individual tolerance for risk and uncertainty, most of the many different investors could match their investment programs with their own investment skills and resources and regularly achieve their own realistic, long-term objectives. This is the important—and not terribly difficult—work of basic investment counseling.

The most valuable professional service we could provide to almost all investors is effective investment counseling. With far too few exceptions, most investment managers currently ignore this important work.[17] Such inattention to the one professional service that is most clearly needed by investors, that would be most valuable to investors, and that would, if done thoroughly, enjoy high probabilities of success is more than ironic. It is the largest problem and the best opportunity for our profession going forward.

An Example of Need. The crucial need for investment counseling for individuals has been magnified by the huge shift in retirement security funds from defined-benefit (DB) to defined-contribution (DC) plans. Arguably the most valuable financial service ever offered to individuals, DB pension plans provide retirees with regular payouts from low-cost, long-term, well-supervised investments and require no investment knowledge or skill, no need for caution at market highs, no need for courage if and when markets collapse, and no concern for outliving the funds.

In contrast, in today's DC plans, 55 million participants are on their own to decide portfolio structure. Nearly 20 percent "invest" entirely in money market funds—because that is how they started out when the balances were small and they have not changed their original allocations. In plans that allow investments in the sponsoring company's own shares, 17 percent of participants have over 40 percent of their accounts in that one company. (As Enron Corporation, Polaroid Corporation, and others have shown, that is potentially painful nondiversification.) For larger numbers of workers, the more serious question is, How many beneficiaries do not realize how much capital it will take to pay out a comfortable monthly amount, and how many of these will run out of funds in their old age? One norm is to limit withdrawals to 4 percent of assets a year. For participants in their mid-50s—with only 10 years to save more—the average balance is now $150,000. At 4 percent, this produces—before taxes and inflation—only $6,000 a year, and even at 6 percent, it only produces $9,000 a year. Ouch!

Helpful Change. Target date or life-cycle funds convert the "do it yourself" investment *products* into a *service* and are a step in the right direction. So are the low-cost computer models offered by the leading 401(k) managers. Investment organizations that are shifting from product-centric to service-centric strategies report highly favorable professional and business results. They make basic investment counseling scalable and encourage the hope that more will be done. For example, instead of just one target date portfolio, why not have three defined by higher, lower, and average appetites for market risk? The U.S. Congress has helped by enabling—rather than, as before, preventing—plan sponsors' advising participants on basic investment decisions. Some of the larger investment managers are taking "toe in the water" steps toward offering advice on which sectors of the market currently appear attractive or unattractive,[18] but they typically leave out the crucial work of understanding the investor's situation, capabilities, and objectives. A few—but only a few—managers are offering an array of investment capabilities and advice on the best mix for specific clients. Much more is yet to be done to close the gap between what is needed and what is made available to investors.

Conclusion: Our Future Promise

Increasing the fit of investment service to the long-term objectives of each investor—moving from *caveat emptor* "product" sales to more durable, shared-understanding *service* relationships—would increase the duration or "loyalty" and thereby the economic value of client–manager relationships. Increasing the duration of client–manager relationships would benefit both clients and investment managers substantially. If the best way to deliver the needed service is to add investment counseling to the existing client–manager relationships to protect and extend them, wouldn't the generous profit margins of the present business absorb the modest expense? Don't we owe it to ourselves and to our profession to redefine our professional mission to include sensible investment counseling so that we and our clients can enjoy a shared understanding and succeed together?

As a profession, let us correct our two errors of commission—defining our mission as "beating the benchmark" and letting the short-run economics of our business dominate the long-term values of our profession. If we correct our error of omission by reaffirming investment counseling in our client relationships—as we certainly could—we and our clients will both benefit in a classic win-win situation.

Our profession's clients and practitioners would all benefit if we devoted less energy to attempting to "win" the loser's game of beating the market and more skill, knowledge, and time to helping clients recognize market realities, understand themselves as investors, and clarify their realistic objectives and then stay the course that is best for each of them.

If we take appropriate action, we can enjoy future success as a trusted profession and as individual professionals. While doing right by our clients, we will be doing right for ourselves when we guide our clients to success in investing's winners' game.

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This article qualifies for 0.5 CE credit, inclusive of 0.5 SER credit.

Notes

1. As kids familiar with the realities of sailing, we terrified our landlubber cousins by going out on a windy day and deliberately tacking close to the wind to cause our small sailboat to heel far over, knowing when the boat seemed most certainly about to capsize that the "righting arm" of the keel was actually even more certain to prevent its tipping any farther.
2. For example, Financial Engines and MarketRiders.
3. Even close observers are hard pressed to isolate the impact of luck versus manager skill when trying to evaluate performance records of investment managers.
4. Of the 20 leading investment managers serving U.S. pension funds 40 years ago, Greenwich Associates' annual research shows that only 1 is still in the top 20. In the United Kingdom, only 2 of the top 20 investment managers of 30 years ago continue to be leaders.
5. *Source:* Lipper Associates.
6. With institutional portfolios turning over, on average, 100 percent a year—with 70–90 different positions, frequent comparisons being made with their "benchmark," and little tolerance for periods of "underperformance"—portfolio managers are understandably hard pressed to keep up with the market, let alone get ahead of their numerous and skillful competitors.
7. Managers of institutional funds often—surely all too often—join in the deception by showing performance data to clients and prospects gross of fees, rather than net of fees. For many years, CFA Institute has advocated reform to address this issue.
8. J.C. Bogle, *Don't Count on It!* (Hoboken, NJ: John Wiley & Sons, 2011):74.
9. Terry Odean of the University of California, Los Angeles, has produced the best available data.
10. A. Goyal and S. Wahal, "The Selection and Termination of Investment Management Firms by Plan Sponsors," *Journal of Finance*, vol. 63, no. 4 (August 2008):1805–1847. (Of course, past performance had strongly favored the hired managers. One is left to wonder whether consultants who focus committee meetings on reviewing "performance" and on getting "better" managers are really more interested in clients' long-term risk-adjusted returns or in convincing clients to continue paying their fees for service.) Behavioral economists note that 80 percent of people rate themselves "above average" on many factors: sense of humor, athletic ability, skill as a conversationalist, capacity for understanding others, parenting, dancing, and so forth.
11. S.D. Stewart, J.J. Neumann, C.R. Knittel, and J. Heisler, "Absence of Value: An Analysis of Investment Allocation Decisions by Institutional Plan Sponsors," *Financial Analysts Journal*, vol. 65, no. 6 (November/December 2009):34–51.
12. See D.F. Swensen, *Unconventional Success: A Fundamental Approach to Personal Investment* (New York: Free Press, 2005).
13. Amazingly, even some index funds charge high fees—as much as 75 bps—for an S&P 500 Index matching fund.
14. The average bond mutual fund expense ratio is 75 bps. With the yield on AAA corporates at 5 percent, an investor pays 15 percent of the return as a fee. With inflation expectations at 2.5 percent, this means bond investors are paying 30 percent of their real expected return on the corporate bond portfolio.
15. The payouts to sellers have also become large—unless you think $1 billion for a first-generation service proprietorship is not large.
16. One explanation for the shift away from counseling by investment managers may be that, as institutions used more numerous and more specialized investment managers, they apparently wanted to separate the two functions and have independent investment consultants monitoring the managers just as outside auditors monitor financial reporting.
17. This is surely indicated by the substantial use of investment consultants, a sub-industry that has grown to fill the investment advisory vacuum left by investment managers. Many consultants give remarkably "generic" investment advice at meetings that focus on the transactions of hiring and firing managers and all too often are staffed by individuals whose real priority is maintaining their book of business by keeping accounts comfortable.
18. Rebalancing to policy asset mix has often added increments to returns.